

MERCHANTS GROUP INC

Form 10-Q

August 10, 2006

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

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the quarterly period ended **June 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 1-9640

MERCHANTS GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

16-1280763

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

250 Main Street, Buffalo, New York

(Address of principal executive offices)

14202

(Zip Code)

716-849-3333

(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, and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer Accelerated filer Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of August 8, 2006:
2,145,652 shares of Common Stock.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

MERCHANTS GROUP, INC.
CONSOLIDATED BALANCE SHEET
(in thousands)

Assets	June 30, 2006 (unaudited)	December 31, 2005
Investments:		
Fixed maturities:		
Available for sale at fair value (amortized cost \$168,755 in 2006 and \$169,666 in 2005)	\$ 162,762	\$ 166,593
Preferred stock at fair value	3,466	4,312
Other long-term investments at fair value	84	734
Short-term investments	7,962	10,650
Total investments	174,274	182,289
Cash	36	82
Interest due and accrued	1,152	998
Premiums receivable from affiliate, net of allowance for doubtful accounts of \$135 in 2006 and \$158 in 2005	12,879	13,540
Deferred policy acquisition costs from affiliate	5,612	6,527
Reinsurance recoverable on unpaid losses	12,440	13,807
Prepaid reinsurance premiums from affiliate	4,097	4,559
Income taxes receivable		109
Deferred income taxes	6,108	5,367
Other assets	6,552	6,700
Total assets	\$ 223,150	\$ 233,978

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.
 CONSOLIDATED BALANCE SHEET
 (in thousands except share amounts)

	June 30, 2006 (unaudited)	December 31, 2005
Liabilities and Stockholders' Equity		
Liabilities:		
Reserve for losses and loss adjustment expenses (affiliate \$49,568 and \$50,239)	\$ 106,515	\$ 115,191
Unearned premiums from affiliate	25,681	29,662
Payable to affiliate	532	113
Income taxes payable	428	
Retrospective commission payable to affiliate	4,464	2,590
Other liabilities (affiliate \$2,904 and \$5,044)	8,392	10,528
Total liabilities	146,012	158,084
Stockholders' equity:		
Common stock, 10,000,000 shares authorized, 2,145,652 and 2,132,652 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively	33	33
Additional paid in capital	36,540	36,267
Treasury stock, 1,139,700 shares at June 30, 2006 and December 31, 2005	(22,766)	(22,766)
Accumulated other comprehensive loss	(4,368)	(2,540)
Accumulated earnings	67,699	64,900
Total stockholders' equity	77,138	75,894
Commitments and contingent liabilities		
Total liabilities and stockholders' equity	\$ 223,150	\$ 233,978

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF OPERATIONS
(in thousands except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(unaudited)			
Revenues:				
Net premiums earned from affiliate	\$ 10,019	\$ 12,767	\$ 20,045	\$ 24,744
Net investment income	2,002	1,908	3,946	3,844
Net investment gains (losses)	42		(68)	
Other revenues from affiliate	77	114	210	250
Total revenues	12,140	14,789	24,133	28,838
Expenses:				
Net losses and loss adjustment expenses (\$5,639, \$5,277, \$10,054 and \$11,473 from affiliate)	4,952	4,617	9,265	11,911
Amortization of deferred policy acquisition costs from affiliate	2,605	3,319	5,212	6,433
Other underwriting expenses (\$1,825, \$2,039, \$3,399 and \$3,903 from affiliate)	2,411	2,321	4,189	4,363
Total expenses	9,968	10,257	18,666	22,707
Income before income taxes	2,172	4,532	5,467	6,131
Income tax provision	638	1,354	1,595	1,765
Net income	\$ 1,534	\$ 3,178	\$ 3,872	\$ 4,366
Earnings per share:				
Basic	\$.71	\$ 1.50	\$ 1.81	\$ 2.07
Diluted	\$.71	\$ 1.50	\$ 1.81	\$ 2.06
Weighted average shares outstanding:				
Basic	2,146	2,114	2,144	2,114
Diluted	2,146	2,119	2,144	2,119

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)
(in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005 (unaudited)	2006	2005
Net income	\$ 1,534	\$ 3,178	\$ 3,872	\$ 4,366
Other comprehensive income (loss) before taxes:				
Unrealized gains (losses) on securities	(1,511)	1,815	(2,838)	(295)
Reclassification adjustment for gains (losses) included in net income	42		(68)	
Other comprehensive income (loss) before taxes	(1,553)	1,815	(2,770)	(295)
Income taxes (benefit) related to items of other comprehensive income (loss)	(528)	617	(942)	(100)
Other comprehensive income (loss)	(1,025)	1,198	(1,828)	(195)
Comprehensive income	\$ 509	\$ 4,376	\$ 2,044	\$ 4,171

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MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
(in thousands)

	Six Months Ended June 30, 2006 2005 (unaudited)	
Common stock beginning and end:	\$ 33	\$ 33
Additional paid in capital:		
Beginning of period	36,267	35,878
Exercise of common stock options	273	
End of period	36,540	35,878
Treasury stock beginning and end:	(22,766)	(22,766)
Accumulated other comprehensive loss:		
Beginning of period	(2,540)	(536)
Other comprehensive loss	(1,828)	(195)
End of period	(4,368)	(731)
Accumulated earnings:		
Beginning of period	64,900	59,365
Net income	3,872	4,366
Dividends to shareholders (to affiliate \$128 and \$51)	(1,073)	(424)
End of period	67,699	63,307
Total stockholders equity	\$ 77,138	\$ 75,721

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS
(in thousands)

	Six Months Ended June 30, 2006 2005 (unaudited)	
Cash flows from operations:		
Collection of premiums from affiliate	\$ 16,900	\$ 21,917
Payment of losses and loss adjustment expenses (affiliate (\$10,725) and (\$11,598))	(16,540)	(18,393)
Payment of other underwriting expenses (affiliate (\$7,562) and (\$8,290))	(8,347)	(8,921)
Investment income received	3,764	4,024
Investment expenses paid	(149)	(207)
Income taxes paid	(857)	(259)
Other from affiliate	210	250
Net cash used in operations	(5,019)	(1,589)
Cash flows from investing activities:		
Proceeds from fixed maturities sold or matured	19,965	29,678
Purchase of fixed maturities	(18,949)	(24,882)
Net (increase) decrease in preferred stock	1,000	(850)
Net decrease in other long-term investments	650	2,072
Net (increase) decrease in short-term investments	2,688	(2,816)
Increase in payable for securities		6,258
Net cash provided by investing activities	5,354	9,460
Cash flows from financing activities:		
Settlement of affiliate balances, net	419	(6,562)
Exercise of common stock options	273	
Cash dividends (to affiliate \$128 and \$51)	(1,073)	(424)
Net cash used in financing activities	(381)	(6,986)
Increase (decrease) in cash	(46)	885
Cash:		
Beginning of period	82	145
End of period	\$ 36	\$ 1,030

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS
RECONCILIATION OF NET INCOME TO NET CASH
USED IN OPERATIONS
(in thousands)

	Six Months Ended June 30,	
	2006	2005
	(unaudited)	
Net income	\$ 3,872	\$ 4,366
Adjustments:		
Net discount accretion on investments	(177)	(66)
Realized investment gains (losses)	68	
Deferred income taxes	201	304
(Increase) decrease in assets:		
Interest due and accrued	(154)	39
Premiums receivable from affiliate	661	707
Deferred policy acquisition costs from affiliate	915	984
Reinsurance recoverable on unpaid losses	1,367	394
Prepaid reinsurance premiums from affiliate	462	(343)
Income taxes receivable	109	
Other assets	148	1,214
Increase (decrease) in liabilities:		
Reserve for losses and loss adjustment expenses (affiliate (\$671) and (\$1,606))	(8,676)	(7,984)
Unearned premiums from affiliate	(3,981)	(3,415)
Income taxes payable	428	1,204
Retrospective commission payable to affiliate	1,874	1,863
Other liabilities (affiliate \$(2,141) and \$(685))	(2,136)	(856)
Net cash used in operations	\$ (5,019)	\$ (1,589)

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Principles of Consolidation and Basis of Presentation

The consolidated balance sheet as of June 30, 2006 and the related consolidated statements of operations and comprehensive income for the three and six month periods ended June 30, 2006 and 2005, and changes in stockholders' equity and cash flows for the six months ended June 30, 2006 and 2005, respectively, are unaudited. In the opinion of management, these interim financial statements reflect all adjustments necessary for a fair presentation of financial position and results of operations. Such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results for a full year.

The consolidated financial statements include the accounts of Merchants Group, Inc. (the Company), its wholly-owned subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH), and M.F.C. of New York, Inc., an inactive premium finance company which is a wholly-owned subsidiary of MNH. The accompanying consolidated financial statements should be read in conjunction with the following notes and the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which differ in some respects from those followed in reports to insurance regulatory authorities. All significant intercompany balances and transactions have been eliminated.

2. Related Party Transactions

The Company and MNH operate and manage their business in conjunction with Merchants Mutual Insurance Company (Mutual) under a services agreement (the Services Agreement) that became effective January 1, 2003. At June 30, 2006 Mutual owned 11.9% of the Company's issued and outstanding common stock. The Company and MNH do not have any operating assets or employees. Under the Services Agreement, Mutual provides the Company and MNH with the facilities, management and personnel required to operate their day-to-day business. The Services Agreement covers substantially the same services previously provided under a management agreement among the Company, MNH and Mutual from 1986 to 2002. The Services Agreement provides for negotiated fees (subject to periodic adjustment) for administrative, underwriting, claims and investment management services.

As of January 1, 2003 MNH and Mutual entered into a reinsurance pooling agreement (the Reinsurance Pooling Agreement) that provides for the pooling, or sharing, of the insurance business traditionally written by Mutual and MNH. The Reinsurance Pooling Agreement applies to premiums earned and losses incurred on or after its effective date.

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The Financial Statements include supplemental disclosure of affiliate balances, which represent the effects of the Services Agreement and the Reinsurance Pooling Agreement. In certain instances, particularly for Net losses and loss adjustment expenses, the affiliate amount may exceed the amount presented in the line item, because of changes in estimates for reserves for losses and loss adjustment expenses (LAE) prior to the effective date of the Reinsurance Pooling Agreement.

The terms of these agreements are more fully described under the heading Administration in Part I, Item 1, Business, in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. In accordance with the terms of the Services Agreement in June 2005 the Company and MNH issued notice to Mutual to terminate the Investment and Cash Management Services Annex of the Services Agreement as of June 30, 2006. In June 2006, the Company and Mutual agreed that Mutual would continue to provide Investment and Cash Management Services to the Company on a month-to-month basis, subject to a thirty-day cancellation notice effective at the end of any calendar month.

3. Earnings Per Share

Basic and diluted earnings per share were computed by dividing net income by the weighted average number of shares of common stock outstanding during each period.

For diluted earnings per share, the weighted average number of shares outstanding was increased by the assumed exercise of options for the three and six month periods ended June 30, 2005. The effect on the number of shares outstanding assumed the proceeds to the Company from exercise were used to purchase shares of the Company's common stock at its average market value per share during the period. The number of options assumed to be exercised and the incremental effect on average shares outstanding for purposes of calculating diluted earnings per share are shown below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Options assumed exercised		31,500		31,500
Incremental shares outstanding		5,022		4,988

There were no options outstanding at June 30, 2006.

The Company is not affected by Statement of Financial Accounting Standards No. 123(R) entitled Share Based Payment as no shared based payments were outstanding at June 30, 2006.

Table of Contents4. Reserve for Loss and Loss Adjustment Expenses

The following table presents the liability for reserves for losses and LAE separated into case reserves, reserves for losses incurred but not reported (IBNR) and reserves for LAE by major product:

	June 30, 2006	December 31, 2005
	(in thousands)	
Case reserves:		
Private passenger auto liability	\$ 6,074	\$ 6,072
Homeowners	1,423	1,899
Commercial auto liability	4,368	5,384
Workers compensation	13,729	14,531
Commercial package	11,072	12,739
General liability	563	505
Other	203	308
Total case reserves	37,432	41,438
IBNR:		
Private passenger auto liability	3,080	4,372
Homeowners	385	228
Commercial auto liability	7,198	6,396
Workers compensation	7,317	8,074
Commercial package	15,522	16,965
General liability	3,364	2,581
Other	(303)	(407)
Total IBNR	36,563	38,209
Reserve for LAE:		
Private passenger auto liability	1,640	2,004
Homeowners	500	604
Commercial auto liability	1,602	1,622
Workers compensation	1,858	2,104
Commercial package	10,344	11,493
General liability	3,962	3,668
Other	174	242
Total reserve for LAE	20,080	21,737
Subtotal	94,075	101,384
Reinsurance recoverables	12,440	13,807
Reserve for losses and LAE	\$ 106,515	\$ 115,191

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Included in the reserve for losses and LAE at June 30, 2006 was \$14,888,000 of reserves for 1996 and prior accident years. Reserves related to workers compensation comprised \$9,237,000 of this amount at June 30, 2006. The following table presents workers compensation claim count and paid loss data for accident years older than ten years as of each date:

	For the six months ended June 30, 2006	For the year ended December 31, 2005
	(dollars in thousands)	
Number of claims pending, beginning of period	84	92
Number of claims reported		
Number of claims settled or dismissed		(16)
Number of claims pending, end of period	84	76
Losses paid (\$000 s)	\$ 411	\$ 599
Loss settlement expenses paid (\$000 s)	\$ 26	\$ 33

The workers compensation claims consist primarily of reserves for the estimated cost of lifetime medical care for injured claimants. In developing the reserves for such claimants, the Company estimates the nature, frequency and duration of future medical treatments and pharmaceutical usage, in some instances for the lifetime of the claimant. Periodic reevaluation of these factors, based on new information on the claimant or changes in medical procedures, devices or pharmaceuticals, may result in changes in estimates for individual claims that are significant to the Company.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations for the Six Months Ended June 30, 2006 As Compared to the Six Months Ended June 30, 2005

The following discussion should be considered in light of the statements under the heading "Safe Harbor Statement" under the Securities Litigation Reform Act of 1995, at the end of this Item. All capitalized terms used in this Item that are not defined in this Item have the meanings given to them in Notes to Consolidated Financial Statements contained in Item 1 of this Form 10-Q, which is incorporated herein by reference.

Results of operations for the six months ended June 30, 2006 and 2005 reflect the effects of the Services Agreement and the Reinsurance Pooling Agreement among the Company and its wholly-owned insurance subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH), and Merchants Mutual Insurance Company (Mutual), effective January 1, 2003. The Services Agreement calls for Mutual to provide underwriting, administrative, claims and investment services to the Company and MNH. The Reinsurance Pooling Agreement provides for the pooling, or sharing, of insurance business traditionally written by Mutual and MNH on or after the effective date. MNH's share of pooled (combined Mutual and MN