

HALLMARK FINANCIAL SERVICES INC
Form 10-Q
November 09, 2011

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 September 30, 2011

Commission file number 001-11252

Hallmark Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
Incorporation or organization)

87-0447375
(I.R.S. Employer
Identification No.)

777 Main Street, Suite 1000, Fort Worth,
Texas
(Address of principal executive offices)

76102
(Zip Code)

Registrant's telephone number, including area code: (817) 348-1600

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value \$.18 per share – 19,263,457 shares outstanding as of November 7, 2011.

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

INDEX TO FINANCIAL STATEMENTS

| | Page Number |
|---|-------------|
| Consolidated Balance Sheets at September 30, 2011 (unaudited) and December 31, 2010 | 3 |
| Consolidated Statements of Operations (unaudited) for the three months and nine months ended September 30, 2011 and September 30, 2010 | 4 |
| Consolidated Statements of Stockholders' Equity and Comprehensive Income (unaudited) for the three months and nine months ended September 30, 2011 and September 30, 2010 | 5 |
| Consolidated Statements of Cash Flows (unaudited) for the nine months ended September 30, 2011 and September 30, 2010 | 6 |
| Notes to Consolidated Financial Statements (unaudited) | 7 |

Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Balance Sheets
(\$ in thousands, except share amounts)

| | September 30 2011 (unaudited) | December 31 2010 |
|--|-------------------------------------|---------------------|
| ASSETS | | |
| Investments: | | |
| Debt securities, available-for-sale, at fair value (cost: \$405,612 in 2011 and \$383,530 in 2010) | \$ 403,244 | \$ 388,399 |
| Equity securities, available-for-sale, at fair value (cost: \$33,424 in 2011 and \$32,469 in 2010) | 41,241 | 44,042 |
| Total investments | 444,485 | 432,441 |
| Cash and cash equivalents | 49,416 | 60,519 |
| Restricted cash | 4,180 | 5,277 |
| Ceded unearned premiums | 18,685 | 25,504 |
| Premiums receivable | 58,159 | 47,337 |
| Accounts receivable | 4,582 | 7,051 |
| Receivable for securities | 11 | 2,215 |
| Reinsurance recoverable | 44,078 | 39,505 |
| Deferred policy acquisition costs | 24,441 | 21,679 |
| Goodwill | 44,695 | 44,695 |
| Intangible assets, net | 27,551 | 30,241 |
| Federal income tax recoverable | 7,156 | 4,093 |
| Deferred federal income taxes, net | 1,801 | - |
| Prepaid expenses | 1,835 | 1,987 |
| Other assets | 13,290 | 15,207 |
| Total assets | \$ 744,365 | \$ 737,751 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| Note payable | \$ 4,050 | \$ 2,800 |
| Subordinated debt securities | 56,702 | 56,702 |
| Reserves for unpaid losses and loss adjustment expenses | 293,201 | 251,677 |
| Unearned premiums | 150,796 | 140,965 |
| Unearned revenue | 73 | 116 |
| Reinsurance balances payable | 2,445 | 3,122 |
| Accrued agent profit sharing | 1,438 | 1,301 |
| Accrued ceding commission payable | 1,139 | 4,231 |
| Pension liability | 2,338 | 2,833 |
| Payable for securities | 5,778 | 2,493 |
| Payable for acquisition | - | 14,000 |
| Deferred federal income taxes, net | - | 4,602 |
| Accounts payable and other accrued expenses | 13,551 | 15,786 |

| | | |
|--|------------|------------|
| Total liabilities | 531,511 | 500,628 |
| Commitments and Contingencies (Note 18) | | |
| Redeemable non-controlling interest | 1,261 | 1,360 |
| Stockholders' equity: | | |
| Common stock, \$.18 par value, authorized 33,333,333 shares in 2011 and 2010; issued 20,872,831 in 2011 and 2010 | 3,757 | 3,757 |
| Additional paid-in capital | 122,355 | 121,815 |
| Retained earnings | 94,692 | 105,816 |
| Accumulated other comprehensive income | 2,347 | 9,637 |
| Treasury stock (1,609,374 shares in 2011 and 748,662 shares in 2010), at cost | (11,558) | (5,262) |
| Total stockholders' equity | 211,593 | 235,763 |
| Liabilities and Equity, Total | \$ 744,365 | \$ 737,751 |

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

Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Statements of Operations
(Unaudited)
(\$ in thousands, except per share amounts)

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|--|------------------------------------|-----------|-----------------------------------|-----------|
| | 2011 | 2010 | 2011 | 2010 |
| Gross premiums written | \$89,751 | \$82,199 | \$270,834 | \$247,238 |
| Ceded premiums written | (11,869) | (10,152) | (37,762) | (29,263) |
| Net premiums written | 77,882 | 72,047 | 233,072 | 217,975 |
| Change in unearned premiums | (2,814) | (1,641) | (16,313) | (10,606) |
| Net premiums earned | 75,068 | 70,406 | 216,759 | 207,369 |
| Investment income, net of expenses | 3,980 | 4,036 | 11,765 | 10,513 |
| Net realized gains | 394 | 311 | 3,177 | 5,757 |
| Finance charges | 1,683 | 1,833 | 5,148 | 5,247 |
| Commission and fees | 2,445 | (392) | 2,617 | (1,204) |
| Other income | 178 | 23 | 203 | 45 |
| Total revenues | 83,748 | 76,217 | 239,669 | 227,727 |
| Losses and loss adjustment expenses | 56,136 | 51,293 | 181,841 | 146,449 |
| Other operating expenses | 24,809 | 21,602 | 71,770 | 65,956 |
| Interest expense | 1,159 | 1,151 | 3,470 | 3,447 |
| Amortization of intangible assets | 897 | 917 | 2,690 | 2,749 |
| Total expenses | 83,001 | 74,963 | 259,771 | 218,601 |
| Income (loss) before tax | 747 | 1,254 | (20,102) | 9,126 |
| Income tax expense (benefit) | 616 | 205 | (9,006) | 2,142 |
| Net income (loss) | 131 | 1,049 | (11,096) | 6,984 |
| Less: Net income attributable to non-controlling interest | 6 | 33 | 28 | 70 |
| Net income (loss) attributable to Hallmark Financial Services, Inc. | \$125 | \$1,016 | \$(11,124) | \$6,914 |
| Net income (loss) attributable to Hallmark Financial Services, Inc. common stockholders: | | | | |
| Basic | \$0.01 | \$0.05 | \$(0.56) | \$0.34 |
| Diluted | \$0.01 | \$0.05 | \$(0.56) | \$0.34 |

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

Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Statements of Stockholders' Equity and Comprehensive Income
(Unaudited)
(\$ in thousands)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------------|------------------------------------|------------------|
| | 2011 | 2010 | 2011 | 2010 |
| Common Stock | | | | |
| Balance, beginning of period | \$3,757 | \$3,757 | \$3,757 | \$3,757 |
| Issuance of common stock upon option exercises | - | - | - | - |
| Balance, end of period | 3,757 | 3,757 | 3,757 | 3,757 |
| Additional Paid-In Capital | | | | |
| Balance, beginning of period | 122,292 | 121,403 | 121,815 | 121,016 |
| Accretion of redeemable noncontrolling interest | (31) | (77) | (37) | (239) |
| Equity based compensation | 94 | 263 | 583 | 852 |
| Exercise of stock options | - | - | (6) | (40) |
| Balance, end of period | 122,355 | 121,589 | 122,355 | 121,589 |
| Retained Earnings | | | | |
| Balance, beginning of period | 94,567 | 104,380 | 105,816 | 98,482 |
| Net income (loss) attributable to Hallmark Financial Services, Inc. | 125 | 1,016 | (11,124) | 6,914 |
| Balance, end of period | 94,692 | 105,396 | 94,692 | 105,396 |
| Accumulated Other Comprehensive Income | | | | |
| Balance, beginning of period | 7,843 | 6,966 | 9,637 | 8,589 |
| Additional minimum pension liability, net of tax | 47 | 36 | 140 | 109 |
| Net unrealized holding (losses) gains arising during period | (5,150) | 3,527 | (4,253) | 7,277 |
| Reclassification adjustment for losses included in net income | (393) | (311) | (3,177) | (5,757) |
| Balance, end of period | 2,347 | 10,218 | 2,347 | 10,218 |
| Treasury Stock | | | | |
| Balance, beginning of period | (10,068) | (5,262) | (5,262) | (5,327) |
| Acquisition of treasury shares | (1,490) | - | (6,401) | - |
| Issuance of treasury stock upon option exercises | - | - | 105 | 65 |
| Balance, end of period | (11,558) | (5,262) | (11,558) | (5,262) |
| Total Stockholders' Equity | \$211,593 | \$235,698 | \$211,593 | \$235,698 |
| Net income (loss) | \$131 | \$1,049 | \$(11,096) | \$6,984 |
| Additional minimum pension liability, net of tax | 47 | 36 | 140 | 109 |
| Net unrealized holding (losses) gains arising during period | (5,150) | 3,527 | (4,253) | 7,277 |

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| | | | | |
|---|------------|---------|-------------|----------|
| Reclassification adjustment for gains included in net income | (393) | (311) | (3,177) | (5,757) |
| Comprehensive (loss) income | (5,365) | 4,301 | (18,386) | 8,613 |
| Less: Comprehensive income attributable to non-controlling interest | 6 | 33 | 28 | 70 |
| Comprehensive (loss) income attributable to Hallmark Financial Services, Inc. | \$(5,371) | \$4,268 | \$(18,414) | \$8,543 |

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

Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)
(\$ in thousands)

| | Nine Months Ended September 30 | |
|---|-----------------------------------|------------------|
| | 2011 | 2010 |
| Cash flows from operating activities: | | |
| Net (loss) income | \$(11,096) | \$6,984 |
| Adjustments to reconcile net (loss) income to cash provided by operating activities: | | |
| Depreciation and amortization expense | 4,103 | 3,527 |
| Deferred federal income taxes | (2,737) | (1,034) |
| Realized gains on investments | (3,177) | (5,757) |
| Change in ceded unearned premiums | 6,819 | (2,523) |
| Change in premiums receivable | (10,283) | (5,653) |
| Change in accounts receivable | 2,515 | 370 |
| Change in deferred policy acquisition costs | (2,762) | (2,389) |
| Change in unpaid losses and loss adjustment expenses | 29,344 | 39,166 |
| Change in unearned premiums | 9,493 | 13,129 |
| Change in unearned revenue | (43) | (51) |
| Change in accrued agent profit sharing | 137 | (18) |
| Change in reinsurance recoverable | (1,117) | (9,676) |
| Change in reinsurance payable | (940) | (2,140) |
| Change in current federal income tax recoverable/payable | (2,888) | (4,386) |
| Change in accrued ceding commission payable | (3,092) | (4,368) |
| Change in all other liabilities | (4,299) | (1,310) |
| Change in all other assets | 5,031 | 5,063 |
| Net cash provided by operating activities | 15,008 | 28,934 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (1,799) | (1,155) |
| Net transfers into restricted cash | 1,097 | (533) |
| Payment for acquisition of subsidiaries, net of cash received | (13,334) | - |
| Purchases of investment securities | (234,994) | (157,332) |
| Maturities, sales and redemptions of investment securities | 229,796 | 99,919 |
| Net cash used in investing activities | (19,234) | (59,101) |
| Cash flows from financing activities: | | |
| Net repayments of notes payable | (410) | - |
| Proceeds from exercise of employee stock options | 99 | 25 |
| Purchase of treasury shares | (6,401) | - |