

MERCHANTS GROUP INC

Form 10-Q

November 13, 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 **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 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 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 October 31, 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)

	September 30, 2006 (unaudited)	December 31, 2005
Assets		
Investments:		
Fixed maturities:		
Available for sale at fair value (amortized cost \$162,897 in 2006 and \$169,666 in 2005)	\$ 159,711	\$ 166,593
Preferred stock at fair value	3,461	4,312
Other long-term investments at fair value	84	734
Short-term investments	12,416	10,650
Total investments	175,672	182,289
Cash	58	82
Interest due and accrued	902	998
Premiums receivable from affiliate, net of allowance for doubtful accounts of \$131 in 2006 and \$158 in 2005	12,507	13,540
Deferred policy acquisition costs from affiliate	5,706	6,527
Reinsurance recoverable on unpaid losses	12,469	13,807
Prepaid reinsurance premiums from affiliate	3,903	4,559
Income taxes receivable		109
Deferred income taxes	5,173	5,367
Other assets	7,000	6,700
Total assets	\$ 223,390	\$ 233,978

See Notes to the Consolidated Financial Statements

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

	September 30, 2006 (unaudited)	December 31, 2005
Liabilities and Stockholders' Equity		
Liabilities:		
Reserve for losses and loss adjustment expenses (affiliate \$50,488 and \$50,239)	\$ 107,180	\$ 115,191
Unearned premiums from affiliate	25,850	29,662
Payable to affiliate	93	113
Retrospective commission payable to affiliate	1,832	2,590
Other liabilities (affiliate \$3,378 and \$5,044)	8,825	10,528
Total liabilities	143,780	158,084
Stockholders' equity:		
Common stock, 10,000,000 shares authorized, 2,145,652 and 2,132,652 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively	33	33
Additional paid in capital	36,540	36,267
Treasury stock, 1,139,700 shares at September 30, 2006 and December 31, 2005	(22,766)	(22,766)
Accumulated other comprehensive loss	(2,517)	(2,540)
Accumulated earnings	68,320	64,900
Total stockholders' equity	79,610	75,894
Commitments and contingent liabilities		
Total liabilities and stockholders' equity	\$ 223,390	\$ 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 September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(unaudited)			
Revenues:				
Net premiums earned from affiliate	\$ 10,699	\$ 12,155	\$ 30,744	\$ 36,899
Net investment income	1,923	1,890	5,869	5,734
Net investment losses			(68)	
Other revenues from affiliate	112	163	322	413
Total revenues	12,734	14,208	36,867	43,046
Expenses:				
Net losses and loss adjustment expenses (\$5,437, \$8,362, \$15,491 and \$19,836 from affiliate)	6,236	7,074	15,501	18,985
Amortization of deferred policy acquisition costs from affiliate	2,782	3,160	7,993	9,594
Other underwriting expenses (\$1,678, \$1,275, \$5,078 and \$5,117 from affiliate)	2,064	1,490	6,254	5,852
Total expenses	11,082	11,724	29,748	34,431
Income before income taxes	1,652	2,484	7,119	8,615
Income tax provision	493	763	2,088	2,528
Net income	\$ 1,159	\$ 1,721	\$ 5,031	\$ 6,087
Earnings per share:				
Basic	\$.54	\$.81	\$ 2.35	\$ 2.88
Diluted	\$.54	\$.81	\$ 2.35	\$ 2.87
Weighted average shares outstanding:				
Basic	2,146	2,114	2,144	2,114
Diluted	2,146	2,120	2,145	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 September 30, 2006		Nine Months Ended September 30, 2005	
	2006	2005	2006	2005
	(unaudited)			
Net income	\$ 1,159	\$ 1,721	\$ 5,031	\$ 6,087
Other comprehensive income (loss) before taxes:				
Unrealized gains (losses) on securities	2,805	(1,797)	(33)	(2,092)
Reclassification adjustment for losses included in net income			68	
Other comprehensive income (loss) before taxes	2,805	(1,797)	35	(2,092)
Income taxes (benefit) related to items of other comprehensive income (loss)	954	(611)	12	(711)
Other comprehensive income (loss)	1,851	(1,186)	23	(1,381)
Comprehensive income	\$ 3,010	\$ 535	\$ 5,054	\$ 4,706

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

	Nine Months Ended September 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 income (loss)	23	(1,381)
End of period	(2,517)	(1,917)
Accumulated earnings:		
Beginning of period	64,900	59,365
Net income	5,031	6,087
Dividends to shareholders (to affiliate \$191 and \$77)	(1,611)	(634)
End of period	68,320	64,818
Total stockholders equity	\$ 79,610	\$ 76,046

See Notes to the Consolidated Financial Statements

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

	Nine Months Ended September 30, 2006 2005 (unaudited)	
Cash flows from operations:		
Collection of premiums from affiliate	\$ 28,439	\$ 35,139
Payment of losses and loss adjustment expenses (affiliate (\$15,242) and (\$15,056))	(22,485)	(26,525)
Payment of other underwriting expenses (affiliate (\$14,394) and (\$13,970))	(15,606)	(14,870)
Investment income received	5,912	5,908
Investment expenses paid	(217)	(308)
Income taxes paid	(1,885)	(1,308)
Other from affiliate	322	412
 Net cash used in operations	 (5,520)	 (1,552)
 Cash flows from investing activities:		
Proceeds from fixed maturities sold or matured	26,919	43,818
Purchase of fixed maturities	(19,949)	(38,860)
Net (increase) decrease in preferred stock	1,000	(850)
Net decrease in other long-term investments	650	2,027
Net (increase) decrease in short-term investments	(1,766)	3,999
Increase in payable for securities		(1,831)
 Net cash provided by investing activities	 6,854	 8,303
 Cash flows from financing activities:		
Settlement of affiliate balances, net	(20)	(6,232)
Exercise of common stock options	273	
Cash dividends (to affiliate \$191 and \$77)	(1,611)	(634)
 Net cash used in financing activities	 (1,358)	 (6,866)
 Decrease in cash	 (24)	 (115)
 Cash:		
Beginning of period	82	145
 End of period	 \$ 58	 \$ 30

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)

	Nine Months Ended September 30, 2006 2005 (unaudited)	
Net income	\$ 5,031	\$ 6,087
Adjustments:		
Net discount accretion on investments	(270)	(110)
Realized investment losses	68	
Deferred income taxes	182	424
(Increase) decrease in assets:		
Interest due and accrued	96	(24)
Premiums receivable from affiliate	1,033	1,094
Deferred policy acquisition costs from affiliate	821	903
Reinsurance recoverable on unpaid losses	1,338	(284)
Prepaid reinsurance premiums from affiliate	656	(337)
Income taxes receivable	109	
Other assets	(300)	1,540
Increase (decrease) in liabilities:		
Reserve for losses and loss adjustment expenses (affiliate \$920 and \$4,780)	(8,011)	(8,535)
Unearned premiums from affiliate	(3,812)	(3,111)
Income taxes payable		797
Retrospective commission payable to affiliate	(758)	90
Other liabilities (affiliate \$(1,667) and \$139)	(1,703)	(86)
Net cash used in operations	\$ (5,520)	\$ (1,552)

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 September 30, 2006 and the related consolidated statements of operations and comprehensive income for the three and nine month periods ended September 30, 2006 and 2005, and changes in stockholders' equity and cash flows for the nine months ended September 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 September 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. On September 29, 2006, the Company and MNH delivered a notice to Mutual confirming that the Company and MNH agreed that if Mutual gives them notice at any time prior to January 1, 2007 of the termination of the Administrative Services Annex to the Services Agreement effective March 31, 2007, neither the Company nor MNH will challenge the timeliness of the notice. The Services Agreement otherwise provides for a 180 days notice of termination for the Administrative Services Annex. The Services Annex to the Services Agreement provides for Mutual to provide the Company and MNH with administrative, accounting, bookkeeping, actuarial services, procurement of legal services related to insurance operations, internal audit services, and other administrative services.

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 nine month periods ended September 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 September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Options assumed exercised		31,500		31,500
Incremental shares outstanding		5,504		5,166

There were no options outstanding at September 30, 2006.

The Company is not affected by Statement of Financial Accounting Standards No. 123(R) entitled Share Based Payment as no share based payments were outstanding at September 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:

	September 30, 2006	December 31, 2005
	(in thousands)	
Case reserves:		
Private passenger auto liability	\$ 5,851	\$ 6,072
Homeowners	1,453	1,899
Commercial auto liability	4,316	5,384
Workers compensation	13,830	14,531
Commercial package	10,462	12,739
General liability	693	505
Other	238	308
Total case reserves	36,843	41,438
IBNR:		
Private passenger auto liability	2,594	4,372
Homeowners	368	228
Commercial auto liability	6,855	6,396
Workers compensation	7,824	8,074
Commercial package	17,424	16,965
General liability	3,234	2,581
Other	(288)	(407)
Total IBNR	38,011	38,209
Reserve for LAE:		
Private passenger auto liability	1,523	2,004
Homeowners	500	604
Commercial auto liability	1,517	1,622
Workers compensation	1,880	2,104
Commercial package	10,219	11,493
General liability	4,031	3,668
Other	187	242
Total reserve for LAE	19,857	21,737
Subtotal	94,711	101,384
Reinsurance recoverables	12,469	13,807
Reserve for losses and LAE	\$ 107,180	\$ 115,191

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The reserve for losses and LAE at September 30, 2006 included \$15,134,000 of reserves for the 1996 and prior accident years. Reserves related to workers compensation comprised \$9,563,000 of this amount at September 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 nine months ended September 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)	\$ 538	\$ 599
Loss settlement expenses paid (\$000 s)	\$ 33	\$ 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

ENTRY INTO MERGER AGREEMENT

On October 31, 2006, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with American European Group, Inc., a Delaware corporation (AEG), and American European Financial, Inc., a newly-formed Delaware corporation that is a wholly owned subsidiary of AEG (Merger Sub), pursuant to which Merger Sub will merge with and into the Company, with the Company surviving the merger. Upon completion of the merger, the Company will be a wholly owned subsidiary of AEG. In the merger, each of the Company's issued and outstanding shares of common stock will be converted into the right to receive \$33.00 per share in cash. The total consideration for the acquisition of the Com