

MEADOWBROOK INSURANCE GROUP INC

Form 10-Q

August 14, 2003

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**Form 10-Q**

**☐ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarter ended June 30, 2003**

**or**

**○ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission File Number 1-14094**

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**Meadowbrook Insurance Group, Inc.**

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

**Michigan**  
*(State of Incorporation)*

**38-2626206**  
*(IRS Employer Identification No.)*

**26600 Telegraph Road, Southfield, Michigan 48034**

*(Address, zip code of principal executive offices)*

**(248) 358-1100**

*(Registrant's telephone number, including area code)*

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

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

The aggregate number of shares of the Registrant's Common Stock, \$.01 par value, outstanding on August 8, 2003 was 29,022,394.

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**Table of Contents****PART 1 FINANCIAL INFORMATION****Item 1 Financial Statements****MEADOWBROOK INSURANCE GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
**For the Six Months Ended June 30,**

	<u>2003</u>	<u>2002</u>
	(Unaudited) (in thousands, except share data)	
Revenues:		
Net premium earned	\$ 63,614	\$ 82,970
Net commissions and fees	24,627	18,932
Net investment income	6,930	6,629
Net realized gains (losses) on investments	579	(301)
Gain on sale of subsidiary		199
	<u>95,750</u>	<u>108,429</u>
Expenses:		
Net loss and loss adjustment expenses	41,295	55,096
Salaries and employee benefits	23,800	18,848
Policy acquisition and other underwriting expenses	9,749	19,934
Other administrative expenses	12,390	11,491
Interest on notes payable	449	2,124
Gain on debt reduction		(359)
	<u>87,683</u>	<u>107,134</u>
Income before income taxes	8,067	1,295
Federal income tax expense	2,632	263
	<u>5,435</u>	<u>1,032</u>
Earnings per share:		
Basic	\$ 0.19	\$ 0.09
Diluted	\$ 0.18	\$ 0.09
Weighted average number of common shares outstanding:		
Basic	29,358,267	11,220,758
Diluted	29,389,101	11,220,758

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

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## MEADOWBROOK INSURANCE GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
For the Quarter Ended June 30,

	2003	2002
	(Unaudited) (in thousands, except share data)	
Revenues:		
Net premium earned	\$ 36,230	\$ 44,313
Net commissions and fees	11,271	9,968
Net investment income	3,577	3,505
Net realized gains (losses) on investments	374	(310)
	<u>51,452</u>	<u>57,476</u>
Expenses:		
Net loss and loss adjustment expenses	24,109	30,638
Salaries and employee benefits	11,868	9,235
Policy acquisition and other underwriting expenses	5,993	10,948
Other administrative expenses	5,306	6,073
Interest on notes payable	212	874
Gain on debt reduction		(359)
	<u>47,488</u>	<u>57,409</u>
Income before income taxes	3,964	67
Federal income tax expense (benefit)	1,285	(55)
	<u>2,679</u>	<u>122</u>
Earnings per share:		
Basic	\$ 0.09	\$ 0.01
Diluted	\$ 0.09	\$ 0.01
Weighted average number of common shares outstanding:		
Basic	29,214,563	13,899,557
Diluted	29,261,119	13,902,073

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

**Table of Contents****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
For the Six Months Ended June 30,**

	<u>2003</u>	<u>2002</u>
	(Unaudited) (in thousands)	
Net income	\$ 5,435	\$ 1,032
Other comprehensive income, net of tax:		
Unrealized gains on securities	2,303	373
Less: reclassification adjustment for (gains) losses included in net income	(229)	199
Other comprehensive income, net of tax	<u>2,074</u>	<u>572</u>
Comprehensive income	<u>\$ 7,509</u>	<u>\$ 1,604</u>

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

**Table of Contents****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
For the Quarter Ended June 30,**

	<u>2003</u>	<u>2002</u>
	(Unaudited) (in thousands)	
Net income	\$ 2,679	\$ 122
Other comprehensive income, net of tax:		
Unrealized gains on securities	2,011	1,976
Less: reclassification adjustment for (gains) losses included in net income	(88)	205
	<u>1,923</u>	<u>2,181</u>
Other comprehensive income, net of tax	1,923	2,181
	<u>4,602</u>	<u>2,303</u>
Comprehensive income	\$ 4,602	\$ 2,303

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



**Table of Contents****MEADOWBROOK INSURANCE GROUP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>June 30, 2003</b>	<b>December 31, 2002</b>
	<b>(Unaudited)</b>	
	<b>(in thousands, except share data)</b>	
<b>ASSETS</b>		
Invested assets:		
Debt securities available for sale, at fair value (cost of \$255,845 and \$231,876)	\$ 271,967	\$ 244,861
Equity securities available for sale, at fair value (cost of \$1,980 and \$1,980)	1,804	1,804
<b>Total invested assets</b>	<b>273,771</b>	<b>246,665</b>
Cash and cash equivalents	33,837	39,385
Premiums and agent balances receivable	77,599	71,420
Reinsurance recoverable on:		
Paid losses	19,660	20,396
Unpaid losses	181,441	181,817
Prepaid reinsurance premiums	21,169	18,115
Deferred policy acquisition costs	17,189	12,140
Deferred federal income taxes	15,529	19,099
Goodwill	28,997	28,997
Other assets	39,966	36,805
<b>Total assets</b>	<b>\$ 709,158</b>	<b>\$ 674,839</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities:		
Reserve for losses and loss adjustment expenses	\$ 369,075	\$ 374,933
Unearned premiums	100,097	68,678
Debt	20,785	32,497
Reinsurance funds held and balances payable	23,473	16,199
Other liabilities	42,283	35,137
<b>Total liabilities</b>	<b>555,713</b>	<b>527,444</b>
Commitments and contingencies (Note 6)		
Shareholders Equity:		
Common stock, \$.01 par value; authorized 50,000,000 shares: 29,022,394 and 29,591,494 shares issued and outstanding	290	296
Additional paid-in capital	125,104	127,429
Retained earnings	18,406	12,073
Note receivable from officer	(902)	(876)
Accumulated other comprehensive income	10,547	8,473
<b>Total shareholders equity</b>	<b>153,445</b>	<b>147,395</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 709,158</b>	<b>\$ 674,839</b>

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



Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Six Months Ended June 30,**

	<u>2003</u>	<u>2002</u>
	(Unaudited)	
	(in thousands)	
Net cash provided by (used in) operating activities	\$ 30,191	\$ (10,795)
Cash flows (used in) provided by investing activities:		
Purchase of debt securities available for sale	(53,453)	(43,576)
Proceeds from sale of debt securities available for sale	29,916	25,788
Proceeds from sale of equity securities available for sale		900
Other investing activities	900	2,880
Net cash used in investing activities	(22,637)	(14,008)
Cash flows (used in) provided by financing activities:		
Net payments on bank loan	(11,712)	(10,659)
Net proceeds from public offering		60,526
Share repurchases	(1,562)	
Other financing activities	172	73
Net cash (used in) provided by financing activities	(13,102)	49,940
(Decrease) increase in cash and cash equivalents	(5,548)	25,137
Cash and cash equivalents, beginning of period	39,385	33,302
Cash and cash equivalents, end of period	\$ 33,837	\$ 58,439

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

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

**Note 1 Summary of Significant Accounting Policies**

***Basis of Presentation***

The consolidated financial statements include accounts, after elimination of intercompany accounts and transactions, of Meadowbrook Insurance Group, Inc. (the Company), its wholly owned subsidiary Star Insurance Company (Star), and Star's wholly owned subsidiaries, Savers Property and Casualty Insurance Company, Williamsburg National Insurance Company, and Ameritrust Insurance Corporation (which collectively are referred to as the Insurance Company Subsidiaries), and American Indemnity Insurance Company, Ltd. and Preferred Insurance Company, Ltd. The consolidated financial statements also include Meadowbrook, Inc. and its subsidiaries, and Crest Financial Corporation and its subsidiaries.

These financial statements and the notes thereto should be read in conjunction with the Company's audited financial statements and accompanying notes included in its Annual Report on Form 10-K for the year ended December 31, 2002.

The consolidated financial statements reflect all normal recurring adjustments, which were, in the opinion of management, necessary to present a fair statement of the results for the interim period. The results of operations for the six months ended June 30, 2003, are not necessarily indicative of the results expected for the full year.

***Revenue Recognition Policy***

Premiums written are recognized as earned on a pro rata basis over the life of the policy term. Unearned premiums represent the portion of premiums written that are applicable to the unexpired terms of policies in force. Provisions for unearned premiums on reinsurance assumed from others are made on the basis of ceding reports when received. Certain premiums are subject to retrospective premium adjustments. The estimated ultimate premium is recognized over the term of the insurance contract.

Commission income, which includes reinsurance brokerage, is recorded on the latter of the effective date or the billing date of the policies on which they were earned. Commission income is reported net of sub-broker commission expense. Commission and other adjustments are recorded when they occur and the Company maintains an allowance for estimated policy cancellations and commission returns.

Fee income, which includes risk management consulting, loss control, and claims services, is recognized in the period the services are provided. The claims processing fees are recognized as revenue over the estimated life of the claims. For those contracts that provide services beyond the contractually defined termination date of the related contracts, fees are deferred in an amount equal to management's estimate of the Company's obligation to continue to provide services.

The Company reviews, on an ongoing basis, the collectibility of its receivables and establishes an allowance for estimated uncollectible accounts.

Realized gains or losses on sale or maturity of investments are determined on the basis of specific costs of the investments. Dividend and interest income are recognized when earned. Discount or premium on debt securities purchased at other than par value is amortized using the constant yield method. Investments with other than temporary declines in fair value are written down to estimated fair value and the related realized losses recognized in income.

***Earnings Per Share***

Basic earnings per share are based on the weighted average number of common shares outstanding during the period, while diluted earnings per share includes the weighted average number of common shares and potential dilution from shares issuable pursuant to stock options using the treasury stock method.

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

Outstanding options of 2,092,149 and 2,764,244 for the six months ended June 30, 2003 and 2002, respectively, have been excluded from the diluted earnings per share as they were anti-dilutive. Shares issuable pursuant to stock options included in diluted earnings per share were 30,834 for the six months ended June 30, 2003. There were no shares issuable pursuant to stock options included in diluted earnings per share for the six months ended June 30, 2002. In addition, outstanding warrants of 300,000 for the six months ended June 30, 2003 and 2002, have been excluded from the diluted earnings per share as they were anti-dilutive.

Outstanding options of 2,092,149 and 2,337,744 for the quarters ended June 30, 2003 and 2002, respectively, have been excluded from the diluted earnings per share as they were anti-dilutive. Shares issuable pursuant to stock options included in diluted earnings per share were 46,556 and 2,048 for the quarters ended June 30, 2003 and 2002, respectively. In addition, shares issuable pursuant to outstanding warrants included in diluted earnings per share were 468 for the quarter ended June 30, 2002. Outstanding warrants of 300,000 for the quarter ended June 30, 2003 have been excluded from the diluted earnings per share as they were anti-dilutive.

***New Accounting Pronouncements***

The Financial Accounting Standards Board ( FASB ) has issued Statement of Financial Accounting Standards ( SFAS ) No. 148 Accounting for Stock-Based Compensation Transition and Disclosure- an amendment of FASB Statement No. 123 , for periods starting after December 15, 2003, or thereafter. SFAS No. 148 provides three optional transition methods for entities that voluntarily adopt the fair value recognition principles of SFAS No 123, Accounting for Stock-Based Compensation , and modifies the disclosure requirements of that Statement. Under the prospective method, stock-based compensation expense is recognized for awards granted after the beginning of the fiscal year in which the change is made. The modified prospective method recognizes stock-based compensation expense related to new and unvested awards in the year of change equal to that which would have been recognized had SFAS No. 123 been adopted as of its effective date, fiscal years beginning after December 15, 1994. The retrospective restatement method recognizes stock compensation costs for the year of change and restates financial statements for all prior periods presented as though the fair value recognition provisions of SFAS No. 123 had been adopted as of its effective date.

The Company, through its 1995 and 2002 Stock Option Plans (the Plans ), may grant options to key executives and other members of management of the Company and its subsidiaries in amounts not to exceed 2,000,000 shares of the Company s common stock allocated for each plan. The plans are administered by the Compensation Committee (the Committee ) of the Board of Directors. Option shares may be exercised subject to the terms of the Plans and the terms prescribed by the Committee at the time of grant. Currently, the Plans options have either five or ten-year terms and are exercisable and vest in equal increments over the option term.

As of January 1, 2003, the Company adopted the requirements of SFAS No. 148 utilizing the prospective method. Under the prospective method, stock-based compensation expense is recognized for awards granted after the beginning of the fiscal year in which the change is made. If compensation cost for stock option grants

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had been determined based on a fair value method, net income and earnings per share on a pro forma basis for the periods ending June 30, 2003 and 2002 would be as follows (in thousands):

	<b>For the Six-Months Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
Net income, as reported	\$ 5,435	\$ 1,032
Add: Stock-based employee compensation expense included in reported income, net of related tax effects	79	
Deduct: Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(515)	(447)
Pro forma net income	<u>\$ 4,999</u>	<u>\$ 585</u>
<b>Earnings per share:</b>		
Basic as reported	\$ 0.19	\$ 0.09
Basic pro forma	\$ 0.17	\$ 0.05
Diluted as reported	\$ 0.18	\$ 0.09
Diluted pro forma	\$ 0.17	\$ 0.05

	<b>For the Quarters Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
Net income, as reported	\$ 2,679	\$ 122
Add: Stock-based employee compensation expense included in reported income, net of related tax effects	22	
Deduct: Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(229)	(242)
Pro forma net income (loss)	<u>\$ 2,472</u>	<u>\$ (120)</u>
<b>Earnings per share:</b>		
Basic as reported	\$ 0.09	\$ 0.01
Basic pro forma	\$ 0.08	\$ (0.01)
Diluted as reported	\$ 0.09	\$ 0.01
Diluted pro forma	\$ 0.08	\$ (0.01)

The Black-Scholes valuation model utilized the following annualized assumptions for all applicable years: Risk-free interest rate of 2.90% and 4.46% for 2003 and 2002, respectively. No dividends were declared in periods ended June 30, 2003 and 2002. The volatility factor for the expected market price of the Company's common stock of 0.586 and 0.562 in 2003 and 2002, respectively. The weighted average expected life of options is 5.0 for the 2003 and 2002 grants.

Compensation expense of \$120,000 has been recorded for stock options granted in the six months ended June 30, 2003 under SFAS. 148. No compensation cost has been recorded for stock option grants issued during 2002 as the market value equaled the exercise price at the date of grant.

**Note 2 Reinsurance**

The Insurance Company Subsidiaries cede insurance to other insurers under pro-rata and excess-of-loss contracts. These reinsurance arrangements diversify the Company's business and minimize its exposure to large losses or from hazards of an unusual nature. The ceding of insurance does not discharge the original insurer from its primary liability to its policyholder. In the event that all or any of the reinsuring companies are unable to meet their obligations, the Insurance Company Subsidiaries would be liable for such defaulted

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

amounts. Therefore, the Company is subject to a credit risk with respect to the obligations of its reinsurers. In order to minimize its exposure to significant losses from reinsurer insolvencies, the Company evaluates the financial condition of its reinsurers and monitors the economic characteristics of the reinsurers on an ongoing basis. The Company also assumes insurance from other insurers and reinsurers, both domestic and foreign, under pro-rata and excess-of-loss contracts.

At June 30, 2003, the Company had reinsurance recoverables for paid and unpaid losses of \$201.1 million. The Company customarily collateralizes reinsurance balances due from non-admitted reinsurers through funds withheld trusts or letters of credit. The largest unsecured reinsurance recoverable is due from an admitted reinsurer with an A A.M. Best rating and accounts for 39.0% of the total recoverable for paid and unpaid losses.

The Company maintains an excess-of-loss reinsurance program designed to protect against large or unusual loss and loss adjustment expense activity. The Company determines the appropriate amount of reinsurance based on the Company's evaluation of the risks accepted and analysis prepared by consultants and reinsurers and on market conditions including the availability and pricing of reinsurance. To date, there have been no material disputes with the Company's excess-of-loss reinsurers. No assurance can be given, however, regarding the future ability of any of the Company's excess-of-loss reinsurers to meet their obligations.

Under the workers' compensation reinsurance program, the Company reinsures each loss in excess of \$300,000 up to a limit of \$50.0 million, under separate treaties. The first treaty reinsures losses in excess of \$300,000 up to a maximum of \$1.0 million. The second treaty reinsures losses in excess of \$1.0 million up to a maximum of \$2.0 million. The third treaty reinsures losses in excess of \$2.0 million up to a maximum coverage including the Company's retention of \$5.0 million. The fourth treaty reinsures losses in excess of \$5.0 million up to a maximum of \$10.0 million. The fifth treaty reinsures losses in excess of \$10.0 million up to a maximum of \$20.0 million. The sixth treaty reinsures losses in excess of \$20.0 million for coverage up to a maximum of \$50.0 million.

Under the liability reinsurance treaty, the reinsurers are responsible for 100% of the amount of each loss in excess of \$350,000 up to a maximum of \$2.0 million per occurrence. A clash layer reinsures losses in excess of \$2.0 million up to a maximum coverage with the Company's retention of \$5.0 million. Clash coverage protects the Company against two casualty policies responding to the same occurrence or coverage to claims settled above stated policy limits.

Under the property reinsurance treaty, the reinsurers are responsible for 100% of the amount of each loss in excess of \$250,000 up to a maximum of \$5.0 million per location for an occurrence. In addition, the reinsurers are responsible for 100% of the excess of \$750,000 up to a maximum of \$20.0 million for a multi-location loss due to a catastrophe. Additional capacity for individual risks may be acquired through facultative reinsurance sources.

In its risk-sharing programs, the Company is also subject to credit risk with respect to the payment of claims by its clients' captive, rent-a-captive, large deductible programs, indemnification agreements, and on the portion of risk exposure either ceded to the captives, or retained by the clients. The capitalization and credit worthiness of prospective risk-sharing partners is one of the factors considered by the Company in entering into and renewing risk-sharing programs. The Company collateralizes balances due from its risk-sharing partners through funds withheld trusts or letters of credit. At June 30, 2003, the Company had risk exposure in excess of collateral in the amount of \$12.7 million, on these programs, for which the Company has an allowance of \$7.6 million, related to these exposures. The Company has historically maintained an allowance for the potential uncollectibility of certain reinsurance balances due from some risk-sharing partners. At the end of each quarter, an analysis of these exposures is conducted to determine the potential exposure to uncollectibility. As of June 30, 2003, management believes that this allowance is adequate. To date, the Company has not, in the aggregate, experienced material difficulties in collecting balances from its risk-sharing partners. No assurance can be given, however, regarding the future ability of any of the



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

Company's risk-sharing partners to meet their obligations. At June 30, 2003, the exposure amount in litigation with former risk-sharing partners which is not reserved or collateralized is \$2.1 million.

**Note 3 Debt**

The Company has a credit agreement which includes a term loan and a revolving line of credit. This credit agreement consists of a \$20.0 million term loan and a revolving line of credit for up to \$8.0 million. The Company uses the revolving line of credit to meet short-term working capital needs. At June 30, 2003, the Company's term loan had an outstanding balance of \$16.5 million. The Company had no outstanding balance on the revolving line of credit at June 30, 2003. At December 31, 2002, the outstanding balance on the term loan and revolving line of credit was \$18.8 million and \$5.3 million, respectively. The term loan calls for quarterly amortization through July 1, 2006, at which time the term loan will be paid in full. The quarterly amortization requires payments of \$1.0 million on April 1, 2003 and July 1, 2003; \$1.5 million on October 1, 2003; and \$1.2 million for the remaining quarterly amortization payments in 2004, 2005, and 2006, with a final payment of \$1.5 million on July 1, 2006. The revolving line of credit will expire on July 1, 2004, and is thereafter renewable on an annual basis.

The Company made principal payments of \$1.2 million on January 1, 2003, and \$1.0 million on April 1, 2003 and July 1, 2003, on the term loan.

Both the term loan and revolving line of credit provide for interest at a variable rate based, at the Company's option, upon either the prime rate or eurocurrency rate. The applicable margin, which ranges from 200 to 300 basis points above eurocurrency rates, is determined by the level of the fixed charge coverage ratio. Of all the covenants, the most restrictive covenant is the fixed charge coverage ratio. The fixed charge coverage ratio, as defined by the credit facility, is the ratio of the non-regulated earnings before interest and taxes for the four preceding fiscal quarters to the sum of fixed charges which include interest expense, principal payments payable, stock repurchases, and dividends declared during the period. Any unused portion of the revolving credit as of the date of determination reduces the sum of these fixed charges. At June 30, 2003, this ratio was 3.3 to 1.0, compared to the covenant minimum of 1.2 to 1.0.

As of June 30, 2003, the Company was in compliance with all debt covenants.

In addition, a non-insurance premium finance subsidiary of the Company maintains a line of credit with a bank, which permits borrowings up to 80% of the accounts receivable, which collateralize the line of credit. At June 30, 2003, this line of credit had an outstanding balance of \$4.3 million.

On January 14, 2003, the Company paid in full a \$3.5 million subordinated promissory note, due June 30, 2003.

**Note 4 Shareholders Equity**

At June 30, 2003, shareholders' equity was \$153.4 million, or \$5.29 per common share, compared to \$147.4 million, or \$4.98 per common share, at December 31, 2002.

On September 17, 2002, the Company's Board of Directors authorized management to repurchase up to 1,000,000 shares of the Company's common stock in market transactions for a period not to exceed twenty-four months. On August 6, 2003, the Company's Board of Directors authorized management to repurchase up to an additional 1,000,000 shares of the Company's common stock under the existing share repurchase plan. As of June 30, 2003, the Company repurchased and retired 764,800 shares of common stock for a total cost of approximately \$2.0 million. For the quarter ended June 30, 2003, the Company repurchased and retired 341,300 shares of common stock for a total cost of approximately \$1.0 million. As of August 8, 2003, the Company repurchased and retired 764,800 shares of common stock for a total cost of approximately \$2.0 million.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 5 Regulatory Matters and Rating Agencies**

A significant portion of the Company's consolidated assets represent assets of the Insurance Company Subsidiaries that at this time, without prior approval of the Michigan Office of Financial and Insurance Services ( OFIS ), cannot be transferred to the holding company in the form of dividends, loans or advances. The restriction on the transferability to the holding company from its Insurance Company Subsidiaries is dictated by Michigan insurance regulatory guidelines which, in general, are as follows: the maximum discretionary dividend that may be declared, based on data from the preceding calendar year, is the greater of each insurance company's net income (excluding realized capital gains) or ten percent of the insurance company's surplus (excluding unrealized gains). These dividends are further limited by a clause in the Michigan law that prohibits an insurer from declaring dividends, except from surplus earnings of the company. Earned surplus balances are calculated on a quarterly basis. Since Star is the parent insurance company, its maximum dividend calculation represents the combined Insurance Company Subsidiaries' surplus. Based upon the 2002 statutory financial statements, Star may only pay dividends to the Company during 2003 with the prior approval of OFIS. Star's earned surplus position at December 31, 2002 was negative \$24.3 million. At June 30, 2003, earned surplus was negative \$27.4 million. No statutory dividends were paid from Star in 2002.

Insurance operations are subject to various leverage tests (e.g. premium to statutory surplus ratios), which are evaluated by regulators and rating agencies. The Company's targets for gross and net written premium to statutory surplus are 3.0 to 1 and 2.0 to 1, respectively. As of June 30, 2003, on a statutory consolidated basis, gross and net premium leverage ratios were 2.3 to 1.0 and 1.7 to 1.0, respectively.

The National Association of Insurance Commissioners ( NAIC ) has adopted a risk-based capital ( RBC ) formula to be applied to all property and casualty insurance companies. The formula measures required capital and surplus based on an insurance company's products and investment portfolio and is used as a tool to evaluate the capital of regulated companies. The RBC formula is used by state insurance regulators to monitor trends in statutory capital and surplus for the purpose of initiating regulatory action. In general, an insurance company must submit a calculation of its RBC formula to the insurance department of its state of domicile as of the end of the previous calendar year. These laws require increasing degrees of regulatory oversight and intervention as an insurance company's RBC declines. The level of regulatory oversight ranges from requiring the insurance company to inform and obtain approval from the domiciliary insurance commissioner of a comprehensive financial plan for increasing its RBC to mandatory regulatory intervention requiring an insurance company to be placed under regulatory control in a rehabilitation or liquidation proceeding.

At December 31, 2002, all of the Insurance Company Subsidiaries were in compliance with RBC requirements. Star reported statutory surplus of \$93.8 million at December 31, 2002, compared to the threshold requiring the minimum regulatory involvement of \$49.7 million in 2002. At June 30, 2003, Star's statutory surplus was \$90.8 million.

The Insurance Company Subsidiaries' A.M. Best financial strength rating is a B+ (Very Good) with a positive outlook. A positive outlook is placed on a company's rating if its financial and market trends are favorable, relative to its current rating level.

**Note 6 Commitments and Contingencies**

The Company is involved in litigation arising in the ordinary course of operations. The Company vigorously defends such litigation. While the results of litigation cannot be predicted with certainty, management is of the opinion, after reviewing these matters with legal counsel, that the final outcome of such litigation will not have a material effect upon the Company's financial statements.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 7 Segment Information**

The Company defines its operations as specialty risk management operations and agency operations based upon differences in products and services. The separate financial information of these segments is consistent with the way results are regularly evaluated by management in deciding how to allocate resources and in assessing performance. Intersegment revenue is eliminated in consolidation.

***Specialty Risk Management Operations***

The specialty risk management operations segment focuses on specialty or niche insurance business in which it provides services and coverages that are tailored to meet the specific requirements of defined client groups and their members. This includes providing services, such as risk management consulting, claims handling, loss control, and reinsurance brokering, along with various types of property and casualty insurance coverage, including workers' compensation, general liability and commercial multiple peril.

***Agency Operations***

The agency operations segment was formed in 1955 as a retail insurance agency. The agency operations have grown to be one of the largest agencies in Michigan and, with acquisitions, have expanded into California. The agency operations produces primarily commercial insurance, as well as personal property, casualty, life, and accident and health insurance, with more than fifty insurance carriers from which it earns commission income.

The following table sets forth the segment results (in thousands):

	<b>For the Six Months Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
<b>Revenues:</b>		
Net earned premiums	\$ 63,614	\$ 82,970
Management fees	10,188	6,582
Claim fees	8,137	3,539
Loss control fees	1,126	1,335
Reinsurance brokerage	161	195
Investment income	6,904	6,603
Net realized gains (losses) on investments	579	(301)
	<hr/>	<hr/>
Specialty risk management segment	90,709	100,923
Agency operations	7,822	7,614
Reconciling items	26	26
Gain on sale of subsidiary		199
Intersegment revenue	(2,807)	(333)
	<hr/>	<hr/>
Consolidated revenue	\$ 95,750	\$ 108,429
	<hr/>	<hr/>
<b>Pre-tax income:</b>		
Specialty risk management	\$ 5,517	\$ (217)
Agency operations*	3,600	3,388
Reconciling items	(1,050)	(2,075)
Gain on sale of subsidiary		199
	<hr/>	<hr/>
Consolidated pre-tax income	\$ 8,067	\$ 1,295
	<hr/>	<hr/>

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\* Excluding the allocation of corporate overhead.

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**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<b>For the Quarters Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
<b>Revenues:</b>		
Net earned premiums	\$ 36,230	\$ 44,313
Management fees	4,840	3,421
Claim fees	3,755	1,805
Loss control fees	549	739
Reinsurance brokerage	106	123
Investment income	3,564	3,492
Net realized gains (losses) on investments	374	(310)
	<u>49,418</u>	<u>53,583</u>
Specialty risk management segment	49,418	53,583
Agency operations	3,675	3,976
Reconciling items	13	13
Intersegment revenue	(1,654)	(96)
	<u>51,452</u>	<u>57,476</u>
Consolidated revenue	\$ 51,452	\$ 57,476
<b>Pre-tax income:</b>		
Specialty risk management	\$ 2,881	\$ (1,099)
Agency operations*	1,548	1,694
Reconciling items	(465)	(528)
	<u>3,964</u>	<u>67</u>
Consolidated pre-tax income	\$ 3,964	\$ 67

\* Excluding the allocation of corporate overhead.

The reconciling item included in the revenue relates to interest income in the holding company. The following table sets forth the pre-tax income reconciling items:

	<b>For the Six Months Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
Holding company expenses	\$ (461)	\$ (310)
Gain on debt reduction		359
Amortization	(140)	
Interest expense	(449)	(2,124)
	<u>(1,050)</u>	<u>(2,075)</u>
	\$ (1,050)	\$ (2,075)

**For the Quarters  
Ended June 30,**

**2003                      2002**

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Holding company expenses	\$ (183)	\$ (13)
Gain on debt reduction		359
Amortization	(70)	
Interest expense	(212)	(874)
	<u>\$ (465)</u>	<u>\$ (528)</u>

**Note 8 Reclassifications**

Certain amounts in the notes and consolidated financial statements have been reclassified to conform to the 2003 presentation.

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**PART I FINANCIAL INFORMATION**

In the opinion of management, the financial statements reflect all adjustments of a normal recurring nature necessary for a fair presentation of the interim periods. Preparation of financial statements under GAAP requires management to make estimates. Actual results could differ from those estimates. Interim results are not necessarily indicative of results expected for the entire year. These financial statements should be read in conjunction with the Company's 2002 Annual Report on Form 10-K, as filed with the Securities and Exchange Commission.

*This quarterly report may provide information including certain statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These include statements regarding the intent, belief, or current expectations of the Company's management, including, but not limited to, those statements that use the words believes, expects, anticipates, estimates, or similar expressions. You are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties, and results could differ materially from those indicated by such forward-looking statements. Among the important factors that could cause actual results to differ materially from those indicated by such forward-looking statements are: the frequency and severity of claims; uncertainties inherent in reserve estimates; catastrophic events; a change in the demand for, pricing of, availability or collectibility of reinsurance; increased rate pressure on premiums; obtainment of certain rate increases in current market conditions; investment rate of return; changes in and adherence to insurance regulation; actions taken by regulators, rating agencies or lenders; obtainment of certain processing efficiencies; changing rates of inflation; general economic conditions and other risks identified in the Company's reports and registration statements filed with the Securities and Exchange Commission. The Company is not under any obligation to (and expressly disclaims any such obligation to) update or alter its forward-looking statements whether as a result of new information, future events or otherwise.*

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**ITEM 2**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF**  
**FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**For the Periods ended June 30, 2003 and 2002**

Meadowbrook Insurance Group, Inc. (the Company) is a publicly traded specialty risk management company, specializing in alternative market insurance and risk management solutions for agents, brokers, professional and trade associations, and insureds of all sizes. The alternative market includes a wide range of approaches to financing and managing risk exposures, such as captives, risk retention and risk purchasing groups, governmental pools and trusts, and self-insurance plans. The alternative market developed as a result of the historical volatility in the cost and availability of traditional commercial insurance coverages, and usually involves some form of self-insurance or risk-sharing on the part of the client. The Company develops and manages alternative risk management programs for defined groups and their members. The Company also operates as an insurance agency representing policyholders in placing their insurance coverages with unaffiliated insurance companies. Management defines its business segments as specialty risk management operations and agency operations.

**Results of Operations for the Six Months Ended June 30, 2003 and 2002***Overview*

Net income for the six months ended June 30, 2003 was \$5.4 million, or \$0.18 per dilutive share, compared to net income of \$1.0 million, or \$0.09 per dilutive share, for the six months ended June 30, 2002. This improvement reflects the addition of new fee-for-service agreements and the Company's continued expense control initiatives. These initiatives have allowed the Company to leverage its fixed costs.

Revenues for the six months ended June 30, 2003 decreased \$12.7 million, or 11.7%, to \$95.7 million from \$108.4 million for the comparable period in 2002.

*Specialty Risk Management Operations*

The following table sets forth the revenues and results from specialty risk management operations (in thousands):

	<b>For the Six Months Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
Revenues:		
Net earned premiums	\$ 63,614	\$ 82,970
Management fees	10,188	6,582
Claim fees	8,137	3,539
Loss control fees	1,126	1,335
Reinsurance brokerage	161	195
Investment income	6,904	6,603
Net realized gain (loss) on investments	579	(301)
<b>Total revenue</b>	<b>\$ 90,709</b>	<b>\$ 100,923</b>
<b>Pre-tax income (loss)</b>	<b>\$ 5,517</b>	<b>\$ (217)</b>

Revenues from specialty risk management operations decreased \$10.2 million, or 10.1%, to \$90.7 million for the six months ended June 30, 2003, from \$100.9 million for the comparable period in 2002. This decrease reflects a \$19.4 million, or 23.3% decrease in net earned premiums to \$63.6 million in the six months ended June 30, 2003, from \$83.0 million in the comparable period in 2002. This decrease is the result of a reduction in earned premium of \$27.4 million related to programs discontinued in 1999 and programs terminated for leverage ratio purposes. Offsetting the overall decrease in net earned premiums is a \$6.9 million increase in





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earned premium related to existing programs and new business and a \$1.1 million reduction in ceded earned premium associated with the cancellation in 2002 of the surplus relief treaty related to several workers' compensation programs.

Management fees increased \$3.6 million, or 54.8%, to \$10.2 million for the six months ended June 30, 2003, from \$6.6 million for the comparable period in 2002. Claim fees increased \$4.6 million, or 129.9%, to \$8.1 million from \$3.5 million for the comparable period in 2002. The increase in management fees and claim fees reflects the previously mentioned addition of new fee-for-service agreements of \$3.4 million and \$5.3 million, respectively. This increase in management fees and claim fees is partially offset by a decrease in discontinued programs and the result of the conversion of an existing fee-based program into an insured program within the Company's underwriting subsidiary. Loss control fees decreased \$209,000, or 15.7%, to \$1.1 million from \$1.3 million for the comparable period in 2002. This decrease is mainly the result of the conversion of an existing fee-based program into an insured program.

Net investment income increased \$301,000, or 4.6%, to \$6.9 million for the six months ended June 30, 2003, compared to \$6.6 million for the comparable period in 2002. This increase reflects a \$59.1 million, or 24.9% increase in average invested assets and cash and cash equivalents, to \$296.8 million for the six months ended June 30, 2003, from \$237.7 million for the comparable period in 2002. The increase in average invested assets and cash and cash equivalents, primarily reflects net assets invested of \$37.5 million from the proceeds received from the Company's public offering in June 2002. In addition, the increase in average invested assets and cash and cash equivalents, was the result of growth in premiums, collection of reinsurance recoverables, and the cancellation of the surplus relief treaty in 2002. The pre-tax yield for June 30, 2003 was 4.6%, compared to 5.6% for the comparable period in 2002.

Specialty risk management operations generated pre-tax income of \$5.5 million for the six months ended June 30, 2003, compared to pre-tax loss of \$217,000 for the comparable period in 2002. This improvement reflects the favorable impact of the previously indicated fee-for-service agreements and improved underwriting results. The generally accepted accounting principles (GAAP) combined ratio was 106.0% for the six months ended June 30, 2003, compared to 107.0% for the same period in 2002.

Net loss and loss adjustment expenses (LAE) decreased \$13.8 million, or 25.1%, to \$41.3 million for the six months ended June 30, 2003, from \$55.1 million for the same period in 2002. The Company's loss and LAE ratio for both periods in 2003 and 2002 was 70.2%. This ratio is the unconsolidated net loss and LAE in relation to net earned premium.

The Company's expense ratio improved 1.0 percentage point to 35.8% for the six months ended June 30, 2003, from 36.8% for the same period in 2002. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premium. The improvement reflects the ability to leverage fixed costs and a reduction in gross commissions. This improvement is partially offset by an increase in insurance related assessments.

**Agency Operations**

The following table sets forth the revenues and results from agency operations (in thousands):

	<b>For the Six Months Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
Net commission	\$ 7,822	\$ 7,614
Pre-tax income*	\$ 3,600	\$ 3,388

\* Excluding the allocation of corporate overhead

Revenue from agency operations, which consists primarily of agency commission revenue, increased \$208,000, or 2.7%, to \$7.8 million for the six months ended June 30, 2003, from \$7.6 million for the comparable period in 2002. This increase is primarily the result of rate increases, increases in contingent

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commissions, and an increase in revenue from new producers. This increase is partially offset by the recognition of \$220,000 in 2002 related to the sale of a book of business and accounts that did not renew with the agency.

Agency operations generated pre-tax income of \$3.6 million for the six months ended June 30, 2003, compared to \$3.4 million for the comparable period in 2002. The improvement in the pre-tax margin is primarily attributable to overall expense reductions.

**Other Items****Reserves**

At June 30, 2003, management's best estimate for the ultimate liability for loss and LAE reserves, net of reinsurance recoverables, was \$187.6 million. Management established a reasonable range of reserves of approximately \$175.7 million to \$200.0 million. This range was established primarily by considering the various indications derived from standard actuarial techniques and other appropriate reserve considerations. The following table sets forth this range by line of business.

Line of Business	Minimum Reserve Range	Maximum Reserve Range	Selected Reserves
Workers Compensation(1)	\$ 93,668	\$ 104,795	\$ 99,604
Commercial Multiple Peril	35,822	44,304	39,558
Commercial Automobile	29,639	32,479	30,635
Other	16,531	18,435	17,837
Net Reserves	\$ 175,660	\$ 200,013	\$ 187,634

**(1) Includes Residual Markets**

Reserves are reviewed by internal and/or independent actuaries for adequacy on a quarterly basis. When reviewing reserves, the Company analyzes historical data and estimates the impact of numerous factors such as (i) per claim information; (ii) Company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the imposition of damages, and changes in political attitudes; and (iv) trends in general economic conditions, including the effects of inflation. This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of reserves, because the eventual deficiency or redundancy is affected by multiple factors.

The key assumptions used in management's selection of ultimate reserves included the underlying actuarial methodologies, a review of current pricing and underwriting initiatives, an evaluation of reinsurance costs and retention levels, and a detailed claims analysis with an emphasis on how aggressive claims handling may be impacting the paid and incurred loss data trends embedded in the traditional actuarial methods. With respect to the ultimate estimates for losses and LAE, the key assumptions remained consistent for the six months ended June 30, 2003 and the years ended December 31, 2002 and 2001.

For the six months ended June 30, 2003, the Company reported an increase in net ultimate loss estimates for accident years 2002 and prior to be \$2.3 million, or 1.2% of \$193.1 million of net loss and LAE reserves at December 31, 2002. The increase in net ultimate loss estimates reflected revisions in the estimated reserves as a result of actual claims activity in calendar year 2003 that differed from the projected activity. There were no

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significant changes in the key assumptions utilized in the analysis and calculations of the Company's reserves during 2003. The major components of this change in ultimates are as follows:

Line of Business	Reserves at December 31, 2002	Incurred Losses			Paid Losses			Reserves at June 30, 2003
		Current Year	Prior Year	Total Incurred	Current Year	Prior Year	Total Paid	
Workers Compensation	\$ 88,888	\$ 19,873	\$ (1,798)	\$ 18,075	\$ 882	\$ 18,245	\$ 19,127	\$ 87,836
Residual Markets	9,496	2,891	1,677	4,568	804	1,492	2,296	11,768
Commercial Multiple Peril	42,936	5,104	1,483	6,587	84	9,881	9,965	39,558
Commercial Automobile	35,547	5,381	1,289	6,670	1,326	10,256	11,582	30,635
Other	16,249	5,795	(400)	5,395	737	3,070	3,807	17,837
Net Reserves	193,116	\$ 39,044	\$ 2,251	\$ 41,295	\$ 3,833	\$ 42,944	\$ 46,777	187,634
Reinsurance Recoverable	181,817							181,441
Consolidated	\$ 374,933							\$ 369,075

Line of Business	Reserves at December 31, 2002	Re-estimated reserves at June 30, 2003 on prior years	Development as a percentage of prior year reserves
Workers Compensation	\$ 88,888	\$ 87,090	(2.0)%
Commercial Multiple Peril	42,936	44,419	3.50 %
Commercial Automobile	35,547	36,836	3.60 %
Other	16,249	15,848	(2.50)%
Sub-total	183,620	184,193	0.3 %
Residual Markets	9,496	11,173	17.7 %
Total Net Reserves	\$ 193,116	\$ 195,366	1.20 %

**Workers Compensation Excluding Residual Markets**

The projected net ultimate loss estimate for the workers' compensation line of business excluding residual markets decreased \$1.8 million, or 2.0% of net workers' compensation reserves. This net overall decrease reflects an increase of \$733,000 in accident year 2002 and a reduction of \$2.5 million in the ultimate estimate for loss and loss adjustment for accident year 2001 and prior. The reduction in loss and allocated expense reserves primarily reflects a decrease in net ultimate loss estimates of \$900,000 in accident year 2001 and \$2.0 million in accident year 2000. The increase in ultimate loss estimates for accident year 2002 reflects higher than expected emergence of claim activity, while the decreases in ultimate loss estimates for accident years 2001 and 2000 reflect lower than expected emergence of claim activity during the six months ended June 30, 2003. The change in ultimate net loss estimates for all other accident years was insignificant.

**Commercial Multiple Peril**

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The commercial multiple peril line of business had an increase in net ultimate loss estimates of \$1.5 million, or 3.5% of net commercial multiple peril reserves. The net increase was \$523,000, \$538,000, and \$512,000 in accident years 2001, 1999, and 1994, respectively. These increases in ultimate loss estimates reflect higher than expected emergence in claim activity during the six months ended June 30, 2003. The change in ultimate net loss estimates for all other accident years was insignificant.

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### **Commercial Automobile**

The commercial automobile line of business had an increase in net ultimate loss estimates of \$1.3 million, or 3.6% of net commercial automobile reserves. The increase in net ultimate loss estimates reflects an increase of \$1.5 million in accident year 2001, primarily from one commercial trucking program which was terminated during 2001. This increase in ultimate loss estimates reflects higher than expected emergence in claim activity during the six months ended June 30, 2003. The change in ultimate net loss estimates for all other accident years was insignificant.

### **Other**

The other lines of business had a decrease in net ultimate loss estimates of \$400,000, or 2.5% of net reserves on the other lines of business. The change reflects a reduction of \$690,000 in accident year 2002, primarily from the property line of business. This decrease in ultimate loss estimates reflects lower than expected emergence in claim activity during the six months ended June 30, 2003. This was partially offset by an increase in net ultimate loss estimates of \$302,000 in the medical line of business primarily in accident years 2000 and 1998. The change in ultimate net loss estimates for all other accident years was insignificant.

### **Residual Markets**

The projected net ultimate loss estimate for the Company's share of the workers' compensation residual markets increased \$1.7 million, or 17.7% of net residual markets reserves. This change reflects the impact of a reporting lag from the residual markets. This reporting lag resulted in an increase of \$1.9 million in the ultimate estimate for loss and allocated loss adjustment in accident year 2002. There is a corresponding change in ultimate premiums of \$1.6 million which is reflected in accident year 2003, as compared to the above mentioned \$1.9 million of losses which is reflected in accident year 2002. The change in ultimate net loss estimates for all other accident years was insignificant.

### ***Salary and Employee Benefits and Other Administrative Expenses***

Salary and employee benefits for the six months ended June 30, 2003, increased \$5.0 million, or 26.3%, to \$23.8 million, from \$18.8 million for the comparable period in 2002. This increase is primarily the result of the hiring of employees to handle new fee-for-service agreements. In addition, this increase reflects both merit increases and a slight increase in staffing levels. Other administrative expenses increased \$899,000, or 7.8%, to \$12.4 million, from \$11.5 million for the comparable period in 2002. The increase in administrative expenses is also attributable to the new fee-for-service agreements. Salary and employee benefits and administrative expenses include both corporate overhead and the holding company expenses included in the reconciling items of the Company's segment information.

### ***Interest Expense***

Interest expense for the six months ended June 30, 2003, decreased by \$1.7 million, or 78.9%, to \$449,000, from \$2.1 million for the comparable period in 2002. Interest expense is primarily attributable to the Company's term loan and revolving line of credit. This decrease reflects both the reduction in the average outstanding balance and a reduction in the average interest rate. The average outstanding balance during the six months ending June 30, 2003, was \$26.6 million, compared to \$53.7 million for the same period in 2002. The average interest rate in 2003 was 3.4%, compared to 7.9% in 2002. The applicable margin in the agreement, which ranges from 200 to 300 basis points above eurocurrency rates, is determined by the level of the fixed charge coverage ratio. The fixed charge coverage ratio, as defined by the credit facility, is the ratio of the non-regulated earnings before interest and taxes for the four preceding fiscal quarters to the sum of fixed charges which include interest expense, principal payments payable, stock repurchases, and dividends declared during the period. Any unused portion of the revolving credit as of the date of determination reduces the sum of these fixed charges. At June 30, 2003, this ratio was 3.3 to 1.0, compared to the covenant minimum of 1.2 to 1.0.

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### *Taxes*

Federal income tax expense for the six months ended June 30, 2003 was \$2.6 million, or 32.6% of income before taxes. For the same period last year, the Company reflected a federal income tax expense of \$263,000, or 20.3% of income before taxes. The increase in tax expense is the result of an increase in earnings. The Company's effective tax rate differs from the 34% statutory rate primarily due to tax-exempt investment income. The overall change in the effective rate in comparison to the six months ended June 30, 2002 is related to changes in the proportion of tax-exempt investment income to total underwriting results.

At June 30, 2003, the Company had a deferred tax asset of \$15.5 million, \$5.9 million of which is related to a net operating loss carryforward (NOL). Realization of the deferred tax asset is dependent on generating sufficient taxable income to absorb both the applicable reversing temporary differences and the NOL. At June 30, 2003, management concluded that the positive evidence supporting the generation of future taxable income sufficient to realize the deferred tax asset outweighed the negative evidence of the cumulative losses reported for the periods ended December 31, 2001, 2000, and 1999. This conclusion was based upon:

The current market conditions that supported the cumulative premium rate increases of 55.0% since the beginning of 2000 is expected to continue;

For the six months ending June 30, 2003, loss reserves continue to stabilize with a calendar year 2003 loss and LAE ratio of 70.2% and net ultimate loss estimates on loss and LAE on prior year accident years of \$2.3 million, or 1.2% of \$193.1 million of net loss and LAE reserves at December 31, 2002;

The completion of the Company's exit of certain discontinued unprofitable programs. Exposures related to these programs were fully earned during the first half of 2002. Furthermore, the uncertainty of future reserve development appears to have been reduced by aggressive claims handling which reduced the number of pending claims, reserve strengthening in 2002, and a claim by claim review conducted by the Company's corporate claims department during the fourth quarter of 2002; and

Alternative tax strategies, which could generate capital gains from the potential sale of assets and/or subsidiaries.

### *Other Than Temporary Impairments*

The Company's policy on other than temporarily impaired securities is to determine impairment based on analysis of the following factors: market value less than 80% of amortized cost for a six month period; rating downgrade or other credit event, e.g., failure to pay interest when due; financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology or discontinuance of a business segment; prospects for the issuer's industry segment; intent and ability of the Company to retain the investment for a period of time sufficient to allow for anticipated recovery in market value. Investments which are determined to be impaired are written down to their estimated net realizable value. At June 30, 2003, the Company did not hold any securities in its investment portfolio that were impaired. As of June 30, 2003, gross unrealized gains and losses on securities were \$16.5 million and (\$570,000), respectively.

## **Results of Operations for the Quarters Ended June 30, 2003 and 2002**

### **Overview**

Net income for the quarter ended June 30, 2003 was \$2.7 million, or \$0.09 per dilutive share, compared to net income of \$122,000, or \$0.01 per dilutive share, for the quarter ended June 30, 2002. This improvement reflects the addition of new fee-for-service agreements and the Company's continued expense control initiatives. These initiatives have allowed the Company to leverage its fixed costs.

Revenues for the quarter ended June 30, 2003 decreased \$6.0 million, or 10.5%, to \$51.5 million from \$57.5 million for the comparable period in 2002.

**Table of Contents*****Specialty Risk Management Operations***

The following table sets forth the revenues and results from specialty risk management operations (in thousands):

	<b>For the Quarters Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
<b>Revenues:</b>		
Net earned premiums	\$ 36,230	\$ 44,313
Management fees	4,840	3,421
Claim fees	3,755	1,805
Loss control fees	549	739
Reinsurance brokerage	106	123
Investment income	3,564	3,492
Net realized gains (losses) on investments	374	(310)
<b>Total revenue</b>	<b>\$ 49,418</b>	<b>\$ 53,583</b>
Pre-tax income (loss)	\$ 2,881	\$ (1,099)

Revenues from specialty risk management operations decreased \$4.2 million, or 7.8%, to \$49.4 million for the quarter ended June 30, 2003, from \$53.6 million for the comparable period in 2002. This decrease reflects an \$8.1 million, or 18.2% decrease in net earned premiums to \$36.2 million in the quarter ended June 30, 2003, from \$44.3 million in the comparable period in 2002. This decrease is the result of a reduction in earned premium of \$9.4 million related to programs discontinued in 1999 and programs terminated for leverage ratio purposes. In addition to the overall decrease in net earned premium, is a \$6.2 million increase in ceded earned premium associated with the cancellation in 2002 of the surplus relief treaty related to several workers' compensation programs. Offsetting the overall decrease in net earned premiums is a \$7.5 million increase in earned premium related to existing programs and new business.

Management fees increased \$1.4 million, or 41.5%, to \$4.8 million for the quarter ended June 30, 2003, from \$3.4 million for the comparable period in 2002. Claim fees increased \$2.0 million, or 108.0%, to \$3.8 million from \$1.8 million for the comparable period in 2002. The increase in management fees and claim fees reflects the previously mentioned addition of new fee-for-service agreements of \$1.6 million and \$2.4 million, respectively. This increase in management fees and claim fees is partially offset by a decrease in discontinued programs and the result of the conversion of an existing fee-based program into an insured program within the Company's underwriting subsidiary. Loss control fees decreased \$190,000, or 25.7%, to \$549,000 from \$739,000 for the comparable period in 2002. This decrease is mainly the result of the conversion of an existing fee-based program into an insured program.

Net investment income increased \$72,000, or 2.1%, to \$3.6 million for the quarter ended June 30, 2003, compared to \$3.5 million for the comparable period in 2002. This increase reflects a \$65.8 million, or 28.0% increase in average invested assets and cash and cash equivalents, to \$300.4 million for the quarter ended June 30, 2003, from \$234.6 million for the comparable period in 2002. The increase in average invested assets and cash and cash equivalents, primarily reflects net assets invested of \$37.5 million from the proceeds received from the Company's public offering in June 2002. In addition, the increase in average invested assets and cash and cash equivalents, was the result of growth in premiums, collection of reinsurance recoverables, and the cancellation of the surplus relief treaty in 2002. The pre-tax yield for June 30, 2003 was 4.6%, compared to 5.6% for the comparable period in 2002.

Specialty risk management operations generated pre-tax income of \$2.9 million for the quarter ended June 30, 2003, compared to pre-tax loss of \$1.1 million for the comparable period in 2002. This improvement reflects the favorable impact of the previously indicated fee-for-service agreements and improved underwriting



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results. The GAAP combined ratio was 106.4% for the quarter ended June 30, 2003, compared to 108.4% for the same period in 2002.

Net loss and LAE decreased \$6.5 million, or 21.3%, to \$24.1 million for the quarter ended June 30, 2003, from \$30.6 million for the same period in 2002. The Company's loss and LAE ratio decreased by 1.5 percentage points to 71.1% for the quarter ended June 30, 2003, from 72.6% for the same period in 2002. This ratio is the unconsolidated net loss and LAE in relation to net earned premium. This improvement in the loss and LAE ratio reflects rate increases achieved in 2002 and 2003, the cancellation of the surplus relief treaty, and the absence of earned premium from discontinued programs. The loss and LAE ratio for the quarter ended June 30, 2003, was impacted by a net loss of \$1.0 million, or 2.8 percentage points, resulting from property damage caused by storms in the Midwest during May 2003.

The Company's expense ratio improved 0.5 percentage points to 35.3% for the quarter ended June 30, 2003, from 35.8% for the same period in 2002. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premium. The improvement reflects the ability to leverage fixed costs and a reduction in gross commissions. This improvement is offset by an increase in insurance related assessments.

**Agency Operations**

The following table sets forth the revenues and results from agency operations (in thousands):

	<b>For the Quarters Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
Net commission	\$ 3,675	\$ 3,976
Pre-tax income*	\$ 1,548	\$ 1,694

\* Excluding the allocation of corporate overhead

Revenue from agency operations, which consists primarily of agency commission revenue, decreased \$301,000, or 7.6%, to \$3.7 million for the quarter ended June 30, 2003, from \$4.0 million for the comparable period in 2002. This decrease is primarily the result of \$220,000 recognized in 2002 related to the sale of a book of business. The remaining decrease is the result of accounts that did not renew with the agency, offset by rate increases, increases in contingent commissions, and an increase in revenue from new producers.

Agency operations generated pre-tax income of \$1.5 million for the quarter ended June 30, 2003, compared to \$1.7 million for the comparable period in 2002. The decrease in the pre-tax margin is the result of the loss of a large account.

**Other Items****Reserves**

For the quarter ended June 30, 2003, the Company reported an increase in net ultimate loss estimates for accident years 2002 and prior to be \$1.9 million, or 1.0% of \$193.1 million of net loss and LAE reserves at December 31, 2002. There were no significant changes in the key assumptions utilized in the analysis and calculations of the Company's reserves during 2003.

**Salary and Employee Benefits and Other Administrative Expenses**

Salary and employee benefits for the quarter ended June 30, 2003 increased \$2.6 million, or 28.5%, to \$11.9 million, from \$9.2 million for the comparable period in 2002. This increase is primarily the result of the hiring of employees to handle new fee-for-service agreements. In addition, this increase reflects both merit increases and a slight increase in staffing levels. Other administrative expenses decreased \$767,000, or 12.6%, to \$5.3 million, from \$6.1 million for the comparable period in 2002. This decrease is primarily due to a reduction in policyholders dividends of \$1.3 million based on a reduction in anticipated policyholder dividend



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payments. Offsetting this decrease is an increase in administrative expenses attributable to the new fee-for-service agreements. Salary and employee benefits and administrative expenses include both corporate overhead and the holding company expenses included in the reconciling items of the Company's segment information.

**Interest Expense**

Interest expense for the quarter ended June 30, 2003 decreased by \$662,000, or 75.7%, to \$212,000, from \$874,000 for the comparable period in 2002. Interest expense is primarily attributable to the Company's term loan and revolving line of credit. This decrease reflects both the reduction in the average outstanding balance and a reduction in the average interest rate. The average outstanding balance during the quarter ended June 30, 2003, was \$20.9 million, compared to \$53.7 million for the same period in 2002. The average interest rate in 2003 was 4.1%, compared to 6.5% in 2002. The applicable margin in the agreement, which ranges from 200 to 300 basis points above eurocurrency rates, is determined by the level of the fixed charge coverage ratio. The fixed charge coverage ratio, as defined by the credit facility, is the ratio of the non-regulated earnings before interest and taxes for the four preceding fiscal quarters to the sum of fixed charges which include interest expense, principal payments payable, stock repurchases, and dividends declared during the period. Any unused portion of the revolving credit as of the date of determination reduces the sum of these fixed charges. This ratio at June 30, 2003, was 3.3 to 1.0, compared to the covenant minimum of 1.2 to 1.0.

**Taxes**

Federal income tax expense for the quarter ended June 30, 2003 was \$1.3 million, or 32.4% of income before taxes. For the same quarter last year, the Company reflected a federal income tax benefit of \$55,000, or 81.1% of income before taxes. The increase in tax expense is the result of an increase in earnings. The Company's effective tax rate differs from the 34% statutory rate primarily due to tax-exempt investment income. The overall change in the effective rate in comparison to the quarter ended June 30, 2002 is related to changes in the proportion of tax-exempt investment income to total underwriting results.

**Liquidity and Capital Resources**

The principal sources of funds for the Company and its subsidiaries are insurance premiums, investment income, proceeds from the maturity and sale of invested assets, risk management fees, and agency commissions. Funds are primarily used for the payment of claims, commissions, salaries and employee benefits, other operating expenses, shareholder dividends, and debt service. The Company generates operating cash flow from non-regulated subsidiaries in the form of commission revenue, outside management fees, and intercompany management fees. These sources of income are used to meet debt service, shareholders' dividends, and other operating expenses of the holding company and the non-regulated subsidiaries, which have been set forth in the table below for the periods ending June 30, 2003 and 2002.

	<b>For the Six Months Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
Net income	\$ 5,435	\$ 1,032
<b>Regulated Subsidiaries</b>		
Net income (loss)	\$ 2,258	\$ (634)
<b>Non-regulated Subsidiaries</b>		
Net income	\$ 3,177	\$ 1,666
Interest, depreciation, and amortization	1,431	3,424
Non-regulated net income, excluding interest, depreciation, and amortization	\$ 4,608	\$ 5,090



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	For the Quarters Ended June 30,	
	2003	2002
Net income	\$ 2,679	\$ 122
<b>Regulated Subsidiaries</b>		
Net income (loss)	\$ 1,392	\$ (1,163)
<b>Non-regulated Subsidiaries</b>		
Net income	\$ 1,287	\$ 1,285
Interest, depreciation, and amortization	684	1,612
Non-regulated net income, excluding interest, depreciation, and amortization	\$ 1,971	\$ 2,897

Cash flow provided by operations for the six months ended June 30, 2003 was \$30.2 million, compared to cash flow used in operations of \$10.8 million for the comparable quarter in 2002. The increase in cash flow from operations primarily reflects growth in written premiums.

The Company has a credit agreement which includes a term loan and a revolving line of credit. This credit agreement consists of a \$20.0 million term loan and a revolving line of credit for up to \$8.0 million. The Company uses the revolving line of credit to meet short-term working capital needs. At June 30, 2003, the Company's term loan had an outstanding balance of \$16.5 million. The Company had no outstanding balance on the revolving line of credit at June 30, 2003. At December 31, 2002, the outstanding balance on the term loan and revolving line of credit was \$18.8 million and \$5.3 million, respectively. The term loan calls for quarterly amortization through July 1, 2006, at which time the term loan will be paid in full. The quarterly amortization requires payments of \$1.0 million on April 1, 2003 and July 1, 2003; \$1.5 million on October 1, 2003; and \$1.2 million for the remaining quarterly amortization payments in 2004, 2005, and 2006, with a final payment of \$1.5 million on July 1, 2006. The revolving line of credit will expire on July 1, 2004, and is thereafter renewable on an annual basis.

The Company made principal payments of \$1.2 million on January 1, 2003, and \$1.0 million on April 1, 2003 and July 1, 2003, on the term loan.

Both the term loan and revolving line of credit provide for interest at a variable rate based, at the Company's option, upon either the prime rate or eurocurrency rate. The applicable margin, which ranges from 200 to 300 basis points above eurocurrency rates, is determined by the level of the fixed charge coverage ratio. Of all the covenants, the most restrictive covenant is the fixed charge coverage ratio. The fixed charge coverage ratio, as defined by the credit facility, is the ratio of the non-regulated earnings before interest and taxes for the four preceding fiscal quarters to the sum of fixed charges which include interest expense, principal payments payable, stock repurchases, and dividends declared during the period. Any unused portion of the revolving credit as of the date of determination reduces the sum of these fixed charges. At June 30, 2003, this ratio was 3.3 to 1.0, compared to the covenant minimum of 1.2 to 1.0.

As of June 30, 2003, the Company was in compliance with all debt covenants.

In addition, a non-insurance premium finance subsidiary of the Company maintains a line of credit with a bank, which permits borrowings up to 80% of the accounts receivable, which collateralize the line of credit. At June 30, 2003, this line of credit had an outstanding balance of \$4.3 million.

On January 14, 2003, the Company paid in full a \$3.5 million subordinated promissory note, due June 30, 2003.

At June 30, 2003, shareholders' equity was \$153.4 million, or \$5.29 per common share, compared to \$147.4 million, or \$4.98 per common share, at December 31, 2002.

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On September 17, 2002, the Company's Board of Directors authorized management to repurchase up to 1,000,000 shares of the Company's common stock in market transactions for a period not to exceed twenty-

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four months. On August 6, 2003, the Company's Board of Directors authorized management to repurchase up to an additional 1,000,000 shares of the Company's common stock under the existing share repurchase plan. As of June 30, 2003, the Company repurchased and retired 764,800 shares of common stock for a total cost of approximately \$2.0 million. For the quarter ended June 30, 2003, the Company repurchased and retired 341,300 shares of common stock for a total cost of approximately \$1.0 million. As of August 8, 2003, the Company repurchased and retired 764,800 shares of common stock for a total cost of approximately \$2.0 million.

A significant portion of the Company's consolidated assets represent assets of the Insurance Company Subsidiaries that at this time, without prior approval of the Michigan Office of Financial and Insurance Services ( OFIS ), cannot be transferred to the holding company in the form of dividends, loans or advances. The restriction on the transferability to the holding company from its Insurance Company Subsidiaries is limited by Michigan insurance regulatory guidelines which, in general, are as follows: the maximum discretionary dividend that may be declared, based on data from the preceding calendar year, is the greater of each insurance company's net income (excluding realized capital gains) or ten percent of the insurance company's surplus (excluding unrealized gains). These dividends are further limited by a clause in the Michigan law that prohibits an insurer from declaring dividends, except from surplus earnings of the company. Earned surplus balances are calculated on a quarterly basis. Since Star is the parent insurance company, its maximum dividend calculation represents the combined Insurance Company Subsidiaries' surplus. Based upon the 2002 statutory financial statements, Star may only pay dividends to the Company during 2003 with the prior approval of OFIS. Star's earned surplus position at December 31, 2002 was negative \$24.3 million. At June 30, 2003, earned surplus was negative \$27.4 million. No statutory dividends were paid in 2002.

## **Regulatory and Rating Issues**

The National Association of Insurance Commissioners ( NAIC ) has adopted a risk-based capital ( RBC ) formula to be applied to all property and casualty insurance companies. The formula measures required capital and surplus based on an insurance company's products and investment portfolio and is used as a tool to evaluate the capital of regulated companies. The RBC formula is used by state insurance regulators to monitor trends in statutory capital and surplus for the purpose of initiating regulatory action. In general, an insurance company must submit a calculation of its RBC formula to the insurance department of its state of domicile as of the end of the previous calendar year. These laws require increasing degrees of regulatory oversight and intervention as an insurance company's RBC declines. The level of regulatory oversight ranges from requiring the insurance company to inform and obtain approval from the domiciliary insurance commissioner of a comprehensive financial plan for increasing its RBC to mandatory regulatory intervention requiring an insurance company to be placed under regulatory control in a rehabilitation or liquidation proceeding.

At December 31, 2002, all of the Insurance Company Subsidiaries were in compliance with RBC requirements. Star reported statutory surplus of \$93.8 million at December 31, 2002, compared to the threshold requiring the minimum regulatory involvement of \$49.7 million in 2002. At June 30, 2003, Star's statutory surplus was \$90.8 million. Statutory accounting principles differ in some respects from generally accepted accounting principles ( GAAP ). These differences, among other differences, include the costs of acquiring and renewing business. Under statutory accounting principles these acquisition costs are expensed as premium is written, while under GAAP these costs are deferred and recognized as premium is earned over the terms of the policies or reinsurance treaties to which the costs relate. At June 30, 2003, deferred policy acquisition costs increased \$5.0 million, or 41.6%, to \$17.2 million, compared to \$12.1 million at December 31, 2002. This increase reflects the increase in gross unearned premiums of \$31.4 million, or 45.7%, to \$100.1 million at June 30, 2003, compared to \$68.7 million at December 31, 2002.

Insurance operations are subject to various leverage tests (e.g. premium to statutory surplus ratios), which are evaluated by regulators and rating agencies. The Company's targets for gross and net written premium to statutory surplus are 3.0 to 1 and 2.0 to 1, respectively. As of June 30, 2003, on a statutory consolidated basis, gross and net premium leverage ratios were 2.3 to 1.0 and 1.7 to 1.0, respectively.

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The Insurance Company Subsidiaries' A.M. Best financial strength rating is a B+ (Very Good) with a positive outlook. A positive outlook is placed on a company's rating if its financial and market trends are favorable, relative to its current rating level.

**New Accounting Pronouncements**

The Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards (SFAS) No. 148 Accounting for Stock-Based Compensation - Transition and Disclosure- an amendment of FASB Statement No. 123, for periods starting after December 15, 2003, or thereafter. SFAS No. 148 provides three optional transition methods for entities that decide to voluntarily adopt the fair value recognition principles of SFAS No. 123, Accounting for Stock-Based Compensation, and modifies the disclosure requirements of that Statement. Under the prospective method, stock-based compensation expense is recognized for awards granted after the beginning of the fiscal year in which the change is made. The modified prospective method recognizes stock-based compensation expense related to new and unvested awards in the year of change equal to that which would have been recognized had SFAS No. 123 been adopted as of its effective date, fiscal years beginning after December 15, 1994. The retrospective restatement method recognizes stock compensation costs for the year of change and restates financial statements for all prior periods presented as though the fair value recognition provisions of SFAS No. 123 had been adopted as of its effective date.

As of January 1, 2003, the Company adopted the requirements of SFAS No. 148 utilizing the prospective method. Under SFAS 148, compensation expense of \$120,000 and \$34,000, has been recorded for stock options granted in the six months and quarter ended June 30, 2003, respectively. No compensation cost has been recorded for stock option grants issued during 2002 as the market value equaled the exercise price at the date of grant.

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

No material changes since December 31, 2002 Annual Report on Form 10-K.

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

The Company carried out an evaluation, as of June 30, 2003, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that all material information relating to the Company (including its consolidated subsidiaries) required to be included in this quarterly report has been made known in a timely manner. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect these internal controls during the quarter ended June 30, 2003.



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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

The information required by this item is included under Note 6 of the Company's Form 10-Q for the six months ended June 30, 2003, which is hereby incorporated by reference.

**Item 4. Submission of Matters to a Vote of Security Holders**

On May 19, 2003, the Company held its Annual Meeting of Shareholders ( Annual Meeting ) to consider and act upon the following proposals:

(1) The election of four (4) members to the Board of Directors of the Company, and

(2) Ratification of the appointment of the Company's independent accountants, PricewaterhouseCoopers, LLP.

The following Directors stood for election at the Annual Meeting: (1) Robert S. Cubbin; (2) Hugh W. Greenberg; (3) Florine Mark; and (4) Irwin F. Swider, Sr. The shareholders re-elected the Directors at the Annual Meeting and therefore, each shall continue in office. The vote tabulation for each Director was: (1) Robert S. Cubbin 27,770,185 in favor and 230,173 abstained; (2) Hugh W. Greenberg 27,781,604 in favor and 218,754 abstained; (3) Florine Mark 27,765,815 in favor and 234,543 abstained; and (4) Irvin F. Swider, Sr. 27,765,813 for and 234,545 abstained. Other Directors continuing in office after the meeting were as follows: Joseph S. Dresner, Ralph Milo, Robert H. Naftaly, David K. Page, Merton J. Segal, Robert W. Sturgis, Bruce E. Thal and Herbert Tyner.

The shareholders ratified the appointment of PricewaterhouseCoopers, LLP by a vote of 27,931,699 in favor, 35,197 against and 33,462 abstained.

**Item 6. Exhibits and Reports on Form 8-K**

(A) The following documents are filed as part of this Report:

Exhibit No.	Description
10.1	First Amendment to and Waiver of Restated Credit Agreement between Meadowbrook Insurance Group, Inc. and Comerica Bank, dated May 23, 2003.
10.2	Second Amendment to Restated Credit Agreement between Meadowbrook Insurance Group, Inc. and Comerica Bank, dated June 30, 2003.
31.1	Certification of Robert S. Cubbin, Chief Executive Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).
31.2	Certification of Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Robert S. Cubbin, Chief Executive Officer of the Corporation.
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation.

(B) Reports on Form 8-K:

The Registrant filed a Current Report on Form 8-K dated May 12, 2003 for the purpose of furnishing the Company's first quarter 2003 earnings release.

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**SIGNATURES**

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

MEADOWBROOK INSURANCE GROUP, INC.

By: /s/ KAREN M. SPAUN

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*Senior Vice President and  
Chief Financial Officer*

Dated: August 14, 2003

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**EXHIBIT INDEX**

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