

HALLMARK FINANCIAL SERVICES INC
Form 10-Q
November 12, 2010

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, 2010

Commission file number 001-11252

Hallmark Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
Incorporation or organization)

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

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

76102
(Zip Code)

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

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

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

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

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

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

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value \$.18 per share – 20,124,169 shares outstanding as of November 10, 2010.

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

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

| | September 30 2010 (unaudited) | December 31 2009 |
|--|-------------------------------------|---------------------|
| ASSETS | | |
| Investments: | | |
| Debt securities, available-for-sale, at fair value (cost; \$353,659 in 2010 and \$287,108 in 2009) | \$ 360,238 | \$ 291,876 |
| Equity securities, available-for-sale, at fair value (cost; \$34,366 in 2010 and \$27,251 in 2009) | 44,025 | 35,801 |
| Total investments | 404,263 | 327,677 |
| Cash and cash equivalents | 81,984 | 112,270 |
| Restricted cash and cash equivalents | 5,991 | 5,458 |
| Premiums receivable | 52,288 | 46,635 |
| Accounts receivable | 2,958 | 3,377 |
| Receivable for securities | 7 | - |
| Ceded unearned premiums | 15,520 | 12,997 |
| Reinsurance recoverable | 19,684 | 10,008 |
| Deferred policy acquisition costs | 23,181 | 20,792 |
| Goodwill | 41,080 | 41,080 |
| Intangible assets, net | 26,124 | 28,873 |
| Federal income tax recoverable | 3,120 | - |
| Prepaid expenses | 1,733 | 923 |
| Other assets | 15,437 | 18,779 |
| Total assets | \$ 693,370 | \$ 628,869 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| Note payable | \$ 2,800 | \$ 2,800 |
| Subordinated debt securities | 56,702 | 56,702 |
| Reserves for unpaid losses and loss adjustment expenses | 223,828 | 184,662 |
| Unearned premiums | 138,218 | 125,089 |
| Unearned revenue | 140 | 191 |
| Reinsurance balances payable | 1,141 | 3,281 |
| Accrued agent profit sharing | 1,772 | 1,790 |
| Accrued ceding commission payable | 4,232 | 8,600 |
| Pension liability | 2,367 | 2,628 |
| Deferred federal income taxes, net | 1,366 | 942 |
| Federal income tax payable | - | 1,266 |
| Payable for securities | 11,609 | 19 |
| Accounts payable and other accrued expenses | 12,209 | 13,258 |
| Total liabilities | 456,384 | 401,228 |

Commitments and contingencies (Note 17)

| | | |
|--|------------|------------|
| Redeemable non-controlling interest | 1,288 | 1,124 |
| Stockholders' equity: | | |
| Common stock, \$0.18 par value (authorized 33,333,333 shares in 2010 and 2009; issued 20,872,831 in 2010 and 2009) | 3,757 | 3,757 |
| Additional paid-in capital | 121,589 | 121,016 |
| Retained earnings | 105,396 | 98,482 |
| Accumulated other comprehensive income | 10,218 | 8,589 |
| Treasury stock, at cost (748,662 shares in 2010 and 757,828 in 2009) | (5,262) | (5,327) |
| Total stockholders' equity | 235,698 | 226,517 |
| | \$ 693,370 | \$ 628,869 |

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

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

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------------|-------------------|------------------|
| | September 30 | | September 30 | |
| | 2010 | 2009 | 2010 | 2009 |
| Gross premiums written | \$ 82,199 | \$ 74,013 | \$ 247,238 | \$ 220,545 |
| Ceded premiums written | (10,152) | (11,222) | (29,263) | (16,714) |
| Net premiums written | 72,047 | 62,791 | 217,975 | 203,831 |
| Change in unearned premiums | (1,641) | 1,447 | (10,606) | (17,844) |
| Net premiums earned | 70,406 | 64,238 | 207,369 | 185,987 |
| Investment income, net of expenses | 4,036 | 3,467 | 10,513 | 11,203 |
| Net realized gains | 311 | 597 | 5,757 | 1,116 |
| Finance charges | 1,833 | 1,525 | 5,247 | 4,324 |
| Commission and fees | (392) | 2,018 | (1,204) | 10,834 |
| Other income | 23 | 58 | 45 | 93 |
| Total revenues | 76,217 | 71,903 | 227,727 | 213,557 |
| Losses and loss adjustment expenses | 51,293 | 40,579 | 146,449 | 115,552 |
| Operating expenses | 21,602 | 23,428 | 65,956 | 71,056 |
| Interest expense | 1,151 | 1,147 | 3,447 | 3,456 |
| Amortization of intangible assets | 917 | 916 | 2,749 | 2,412 |
| Total expenses | 74,963 | 66,070 | 218,601 | 192,476 |
| Income before tax | 1,254 | 5,833 | 9,126 | 21,081 |
| Income tax expense | 205 | 1,585 | 2,142 | 5,766 |
| Net income | 1,049 | 4,248 | 6,984 | 15,315 |
| Less: Net income attributable to non-controlling interest | 33 | 34 | 70 | 36 |
| Net income attributable to Hallmark Financial Services, Inc. | \$ 1,016 | \$ 4,214 | \$ 6,914 | \$ 15,279 |
| Net income per share attributable to Hallmark Financial Services, Inc. common stockholders: | | | | |
| Basic | \$ 0.05 | \$ 0.20 | \$ 0.34 | \$ 0.73 |
| Diluted | \$ 0.05 | \$ 0.20 | \$ 0.34 | \$ 0.73 |

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

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-------------------|------------------------------------|-------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Common Stock | | | | |
| Balance, beginning of period | \$ 3,757 | \$ 3,757 | \$ 3,757 | \$ 3,751 |
| Issuance of common stock upon option exercises | - | - | - | 6 |
| Balance, end of period | 3,757 | 3,757 | 3,757 | 3,757 |
| Additional Paid-In Capital | | | | |
| Balance, beginning of period | 121,403 | 120,736 | 121,016 | 119,928 |
| Accretion of redeemable noncontrolling interest | (77) | (87) | (239) | (259) |
| Equity based compensation | 263 | 612 | 852 | 1,488 |
| Exercise of stock options | - | - | (40) | 104 |
| Balance, end of period | 121,589 | 121,261 | 121,589 | 121,261 |
| Retained Earnings | | | | |
| Balance, beginning of period | 104,380 | 84,972 | 98,482 | 72,242 |
| Adjustment to opening balance, net of tax (Note 2) | - | - | - | 1,665 |
| | 104,380 | 84,972 | 98,482 | 73,907 |
| Net income attributable to Hallmark Financial Services, Inc. | 1,016 | 4,214 | 6,914 | 15,279 |
| Balance, end of period | 105,396 | 89,186 | 105,396 | 89,186 |
| Accumulated Other Comprehensive Income (Loss) | | | | |
| Balance, beginning of period | 6,966 | 836 | 8,589 | (16,432) |
| Adjustment to opening balance, net of tax (Note 2) | - | - | - | (1,665) |
| Adjusted balance, beginning of period | 6,966 | 836 | 8,589 | (18,097) |
| Additional minimum pension liability, net of tax | 36 | 80 | 109 | 239 |
| Net unrealized holding gains arising during period | 3,527 | 7,881 | 7,277 | 27,197 |
| Reclassification adjustment for gains included in net income | (311) | (636) | (5,757) | (1,178) |
| Balance, end of period | 10,218 | 8,161 | 10,218 | 8,161 |
| Treasury Stock | | | | |
| Balance, beginning of period | (5,262) | (77) | (5,327) | (77) |
| Acquisition of treasury shares | - | (5,250) | - | (5,250) |
| Issuance of treasury stock upon option exercises | - | - | 65 | - |
| Balance, end of period | (5,262) | (5,327) | (5,262) | (5,327) |
| Total Stockholders' Equity | \$ 235,698 | \$ 217,038 | \$ 235,698 | \$ 217,038 |
| Net income | \$ 1,049 | \$ 4,248 | \$ 6,984 | \$ 15,315 |

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| | | | | |
|--|----------|-----------|----------|-----------|
| Additional minimum pension liability, net of tax | 36 | 80 | 109 | 239 |
| Net unrealized holding gains arising during period | 3,527 | 7,881 | 7,277 | 27,197 |
| Reclassification adjustment for gains included in net income | (311) | (636) | (5,757) | (1,178) |
| Comprehensive income | 4,301 | 11,573 | 8,613 | 41,573 |
| Less: Comprehensive income attributable to non-controlling interest | 33 | 34 | 70 | 36 |
| Comprehensive income attributable to Hallmark Financial Services, Inc. | \$ 4,268 | \$ 11,539 | \$ 8,543 | \$ 41,537 |

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

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

| | Nine Months Ended September 30 | |
|--|-----------------------------------|-----------|
| | 2010 | 2009 |
| Cash flows from operating activities: | | |
| Net income | \$ 6,984 | \$ 15,315 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Depreciation and amortization expense | 3,527 | 2,979 |
| Deferred federal income taxes | (1,034) | (1,117) |
| Realized gains on investments | (5,757) | (1,116) |
| Change in ceded unearned premiums | (2,523) | (5,036) |
| Change in premiums receivable | (5,653) | (4,787) |
| Change in accounts receivable | 370 | 815 |
| Change in deferred policy acquisition costs | (2,389) | (3,105) |
| Change in reserves for unpaid losses and loss adjustment expenses | 39,166 | 15,252 |
| Change in unearned premiums | 13,129 | 23,462 |
| Change in unearned revenue | (51) | (1,771) |
| Change in accrued agent profit sharing | (18) | (243) |
| Change in reinsurance recoverable | (9,676) | 5,087 |
| Change in reinsurance balances payable | (2,140) | 2,680 |
| Change in current federal income tax recoverable/payable | (4,386) | (384) |
| Change in accrued ceding commission payable | (4,368) | (5) |
| Change in all other liabilities | (1,310) | (8,094) |
| Change in all other assets | 5,063 | 5,763 |
| Net cash provided by operating activities | 28,934 | 45,695 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (1,155) | (907) |
| Net transfers (into)/from restricted cash and cash equivalents | (533) | 3,470 |
| Purchases of investment securities | (157,332) | (74,430) |
| Maturities, sales and redemptions of investment securities | 99,919 | 65,283 |
| Payment for acquisition of subsidiaries | - | (7,246) |
| Net cash used in investing activities | (59,101) | (13,830) |
| Cash flows from financing activities: | | |
| Proceeds from exercise of employee stock options | 25 | 110 |
| Net repayments of notes payable | - | (1,417) |
| Distribution to non-controlling interest | (144) | (20) |
| Purchase of treasury shares | - | (5,250) |
| Net cash used in financing activities | (119) | (6,577) |
| Increase (Decrease) in cash and cash equivalents | (30,286) | 25,288 |

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| | | |
|--|-----------|-----------|
| Cash and cash equivalents at beginning of period | 112,270 | 59,134 |
| Cash and cash equivalents at end of period | \$ 81,984 | \$ 84,422 |

Supplemental cash flow information:

| | | |
|---------------|----------|----------|
| Interest paid | \$ 3,442 | \$ 3,494 |
| Taxes paid | \$ 7,564 | \$ 7,267 |

Supplemental schedule of non-cash investing activities:

| | | |
|--|-----------|------------|
| Change in receivable for securities related to investment disposals settled after the balance sheet date | \$ 42 | \$ 850 |
| Change in payable for securities related to investment purchases settled after the balance sheet date | \$ 11,590 | \$ (2,918) |

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

Hallmark Financial Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Unaudited)

1. General

Hallmark Financial Services, Inc. (“Hallmark” and, together with subsidiaries, “we,” “us” or “our”) is an insurance holding company engaged in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing our insurance products, as well as providing other insurance related services.

We pursue our business activities through subsidiaries whose operations are organized into five business units, which are supported by our four insurance company subsidiaries. Our Standard Commercial business unit (formerly known as our AHIS Operating Unit) handles commercial insurance products and services in the standard market. Our E&S Commercial business unit (formerly known as our TGA Operating Unit) handles primarily commercial insurance products and services in the excess and surplus lines market. Our General Aviation business unit (formerly known as our Aerospace Operating Unit) handles general aviation insurance products and services. Our Excess & Umbrella business unit (formerly known as our Heath XS Operating Unit) offers low and middle market commercial umbrella and excess liability insurance on both an admitted and non-admitted basis focusing primarily on trucking, specialty automobile and non-fleet automobile coverage. Our Personal Lines business unit (formerly known as our Personal Lines Operating Unit) handles personal insurance products and services. Our insurance company subsidiaries supporting these business units are American Hallmark Insurance Company of Texas (“AHIC”), Hallmark Insurance Company (“HIC”), Hallmark Specialty Insurance Company (“HSIC”) and Hallmark County Mutual Insurance Company (“HCM”).

These five business units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment presently consists solely of the Standard Commercial business unit and the Personal Segment presently consists solely of the Personal Lines business unit. The Specialty Commercial Segment includes the E&S Commercial, General Aviation and Excess & Umbrella business units.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial reporting. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2009 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of September 30, 2010 and 2009 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended September 30, 2010 are not necessarily indicative of the operating results to be expected for the full year.

Redeemable Non-Controlling Interest

We are accreting the redeemable non-controlling interest to its redemption value from the date of issuance to the earliest determinable redemption date, August 29, 2012, using the interest method. Changes in redemption value are considered a change in accounting estimate. We follow the two class method of computing earnings per share. We treat only the portion of the periodic adjustment to the redeemable non-controlling interest carrying amount that reflects a redemption in excess of fair value as being akin to an actual dividend. (See Note 3, "Business Combinations.")

Reclassification

Certain previously reported amounts have been reclassified in order to conform to our current year presentation. Such reclassifications had no effect on net income or stockholders' equity.

Income Taxes

We file a consolidated federal income tax return. Deferred federal income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end. Deferred taxes are recognized using the liability method, whereby tax rates are applied to cumulative temporary differences based on when and how they are expected to affect the tax return. Deferred tax assets and liabilities are adjusted for tax rate changes in effect for the year in which these temporary differences are expected to be recovered or settled.

Use of Estimates in the Preparation of the Financial Statements

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our consolidated financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Refer to "Critical Accounting Estimates and Judgments" in our Annual Report on Form 10-K for the year ended December 31, 2009 for information on accounting policies that we consider critical in preparing our consolidated financial statements. Actual results could differ materially from those estimates.

Fair Value of Financial Instruments

Fair value estimates are made at a point in time, based on relevant market data as well as the best information available about the financial instruments. Fair value estimates for financial instruments for which no or limited observable market data is available are based on judgments regarding current economic conditions, credit and interest rate risk. These estimates involve significant uncertainties and judgments and cannot be determined with precision. As a result, such calculated fair value estimates may not be realizable in a current sale or immediate settlement of the instrument. In addition, changes in the underlying assumptions used in the fair value measurement technique, including discount rate and estimates of future cash flows, could significantly affect these fair value estimates.

Investment Securities: Fair values for debt securities and equity securities are obtained from an independent pricing service or based on quoted market prices. (See Note 4, "Fair Values" and Note 5, "Investments.")

Cash and Cash Equivalents: The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Restricted Cash and Cash Equivalents: The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Notes Payable: The carrying value of our bank credit facility of \$2.8 million approximates the fair value based on the current interest rate.

Subordinated Debt Securities: Our trust preferred securities have a carried value of \$56.7 million and a fair value of \$54.8 million as of September 30, 2010. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 7.50% based on similar issues to discount future cash flows.

For accrued investment income, amounts recoverable from reinsurers, federal income tax recoverable/payable and other assets and liabilities, the carrying amounts approximate fair value because of the short maturity of such financial instruments.

Variable Interest Entities