

HALLMARK FINANCIAL SERVICES INC  
Form 10-Q  
May 08, 2012

**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 March 31, 2012

Commission file number 001-11252

**Hallmark Financial Services, Inc.**

(Exact name of registrant as specified in its charter)

Nevada 87-0447375  
(State or other jurisdiction of (I.R.S. Employer  
Incorporation or organization) Identification No.)

Edgar Filing: HALLMARK FINANCIAL SERVICES INC - Form 10-Q

777 Main Street, Suite 1000, Fort Worth, Texas 76102

(Address of principal executive offices) (Zip Code)

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

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value \$.18 per share – 19,263,457 shares outstanding as of May 8, 2012.

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

INDEX TO FINANCIAL STATEMENTS

	Page Number
Consolidated Balance Sheets at March 31, 2012 (unaudited) and December 31, 2011	3
Consolidated Statements of Operations (unaudited) for the three months ended March 31, 2012 and March 31, 2011	4
Consolidated Statements of Comprehensive Income (Loss) (unaudited) for the three months ended March 31, 2012 and March 31, 2011	5
Consolidated Statements of Stockholders' Equity (unaudited) for the three months ended March 31, 2012 and March 31, 2011	6
Consolidated Statements of Cash Flows (unaudited) for the three months ended March 31, 2012 and March 31, 2011	7
Notes to Consolidated Financial Statements (unaudited)	8

**Hallmark Financial Services, Inc. and Subsidiaries****Consolidated Balance Sheets**

(\$ in thousands, except share amounts)

	March 31 2012 (unaudited)	December 31 2011 (as adjusted)
<b>ASSETS</b>		
Investments:		
Debt securities, available-for-sale, at fair value (cost: \$400,376 in 2012 and \$380,578 in 2011)	\$ 402,394	\$ 380,469
Equity securities, available-for-sale, at fair value (cost: \$30,376 in 2012 and \$30,465 in 2011)	44,085	44,159
Total investments	446,479	424,628
Cash and cash equivalents	70,215	74,471
Restricted cash	7,697	9,372
Ceded unearned premiums	19,518	19,470
Premiums receivable	62,744	53,513
Accounts receivable	3,617	3,946
Receivable for securities	448	2,617
Reinsurance recoverable	44,154	42,734
Deferred policy acquisition costs	24,543	22,554
Goodwill	44,695	44,695
Intangible assets, net	25,758	26,654
Federal income tax recoverable	6,500	6,738
Prepaid expenses	1,936	1,458
Other assets	13,122	13,209
Total assets	\$ 771,426	\$ 746,059
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities:		
Revolving credit facility payable	\$ 1,550	\$ 4,050
Subordinated debt securities	56,702	56,702
Reserves for unpaid losses and loss adjustment expenses	305,716	296,945
Unearned premiums	153,905	146,104
Unearned revenue	58	55
Reinsurance balances payable	4,161	3,139
Accrued agent profit sharing	451	959
Accrued ceding commission payable	1,068	1,071
Pension liability	3,840	3,971
Payable for securities	10,345	203

Edgar Filing: HALLMARK FINANCIAL SERVICES INC - Form 10-Q

Deferred federal income taxes, net	631	135
Accounts payable and other accrued expenses	14,498	15,869
Total liabilities	552,925	529,203
Commitments and Contingencies (Note 17)		
Redeemable non-controlling interest	1,142	1,284
Stockholders' equity:		
Common stock, \$.18 par value, authorized 33,333,333 shares in 2012 and 2011; issued 20,872,831 in 2012 and 2011	3,757	3,757
Additional paid-in capital	122,644	122,487
Retained earnings	94,611	94,440
Accumulated other comprehensive income	7,905	6,446
Treasury stock (1,609,374 shares in 2012 and 2011), at cost	(11,558 )	(11,558 )
Total stockholders' equity	217,359	215,572
	\$ 771,426	\$ 746,059

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 March 31	
	2012	2011 (as adjusted)
Gross premiums written	\$97,395	\$89,712
Ceded premiums written	(12,433)	(13,478)
Net premiums written	84,962	76,234
Change in unearned premiums	(7,754 )	(6,121 )
Net premiums earned	77,208	70,113
Investment income, net of expenses	3,846	4,007
Net realized (losses) gains	(119 )	1,119
Finance charges	1,640	1,740
Commission and fees	180	415
Other income	231	14
Total revenues	82,986	77,408
Losses and loss adjustment expenses	54,791	63,785
Other operating expenses	25,932	23,153
Interest expense	1,149	1,158
Amortization of intangible assets	897	897
Total expenses	82,769	88,993
Income (loss) before tax	217	(11,585)
Income tax expense (benefit)	23	(386 )
Net income (loss)	194	(11,199)
Less: Net income attributable to non-controlling interest	23	14
Net income (loss) attributable to Hallmark Financial Services, Inc.	\$ 171	\$(11,213)
Net income (loss) per share attributable to Hallmark Financial Services, Inc. common stockholders:		
Basic	\$0.01	\$(0.56 )
Diluted	\$0.01	\$(0.56 )

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

**HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

(Unaudited)

(\$ In thousands)

	Three Months Ended March 31,	
	2012	2011 (as adjusted)
Net income (loss)	\$ 194	\$(11,199 )
Other comprehensive income (loss):		
Change in net actuarial gain	120	71
Tax effect on change in net actuarial gain	(42 )	(25 )
Unrealized holding gains (losses) arising during the period	2,024	(1,152 )
Tax effect on unrealized holding gains (losses) arising during the period	(709 )	403
Reclassification adjustment for gains (losses) included in net income	101	(1,119 )
Tax effect on reclassification adjustment for gains (losses) included in net income	(35 )	392
Other comprehensive income (loss), net of tax	1,459	(1,430 )
Comprehensive income (loss)	\$ 1,653	\$(12,629 )
Less: comprehensive income attributable to non-controlling interest	23	14
Comprehensive income (loss) attributable to Hallmark Financial Services, Inc.	\$ 1,630	\$(12,643 )

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



**Hallmark Financial Services, Inc. and Subsidiaries****Consolidated Statements of Stockholders' Equity**

(Unaudited)

(\$ in thousands)

	Three Months Ended March 31,	
	2012	2011 (as adjusted)
<b>Common Stock</b>		
Balance, beginning of period	\$3,757	\$3,757
Balance, end of period	3,757	3,757
<b>Additional Paid-In Capital</b>		
Balance, beginning of period	122,487	121,815
Accretion of redeemable noncontrolling interest	19	(3 )
Equity based compensation	138	262
Balance, end of period	122,644	122,074
<b>Retained Earnings</b>		
Balance, beginning of period	94,995	105,816
Cumulative effect of adjustments resulting from adoption of change in accounting principle, net of tax	(555 )	(485 )
Net income (loss) attributable to Hallmark Financial Services, Inc.	171	(11,213 )
Balance, end of period	94,611	94,118
<b>Accumulated Other Comprehensive Income</b>		
Balance, beginning of period	6,446	9,637
Additional minimum pension liability, net of tax	78	46
Net unrealized holding gains (losses) arising during period, net of tax	1,315	(749 )
Reclassification adjustment for gains (losses) included in net income, net of tax	66	(727 )
Balance, end of period	7,905	8,207
<b>Treasury Stock</b>		
Balance, beginning of period	(11,558 )	(5,262 )
Balance, end of period	(11,558 )	(5,262 )

Total Stockholders' Equity	\$217,359	\$222,894
----------------------------	-----------	-----------

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)

	<b>Three Months Ended March 31</b>	
	<b>2012</b>	<b>2011 (as adjusted)</b>
Cash flows from operating activities:		
Net income (loss)	\$ 194	\$ (11,199 )
Adjustments to reconcile net income (loss) to cash provided by (used) in operating activities:		
Depreciation and amortization expense	1,110	1,224
Deferred federal income taxes	(305 )	(541 )
Net realized (losses) gains	119	(1,119 )
Share-based payments expense	138	262
Change in ceded unearned premiums	(48 )	3,360
Change in premiums receivable	(11,026 )	(8,309 )
Change in accounts receivable	329	(3)
Change in deferred policy acquisition costs	(1,989 )	(1,284 )
Change in unpaid losses and loss adjustment expenses	8,771	17,057
Change in unearned premiums	7,801	2,761
Change in unearned revenue	3	(7)
Change in accrued agent profit sharing	(508 )	(627 )
Change in reinsurance recoverable	(1,420 )	(4,370 )
Change in reinsurance payable	1,022	(2,322 )
Change in current federal income tax recoverable	238	127
Change in accrued ceding commission payable	(3 )	-
Change in all other liabilities	292	(844 )
Change in all other assets	95	(146 )
Net cash provided by (used in) operating activities	4,813	(5,980 )
Cash flows from investing activities:		
Purchases of property and equipment	(34 )	(667 )
Net transfers from restricted cash	1,675	2,487
Payment for acquisition of subsidiaries	-	(14,000 )
Purchases of investment securities	(37,108 )	(72,172 )
Maturities, sales and redemptions of investment securities	29,045	74,512
Net cash used in investing activities	(6,422 )	(9,840 )
Cash flows from financing activities:		
Activity under revolving credit facility	(2,500 )	-

Edgar Filing: HALLMARK FINANCIAL SERVICES INC - Form 10-Q

Distribution to non-controlling interest	(147 )	-
Net cash used in financing activities	(2,647 )	-
Decrease in cash and cash equivalents	(4,256 )	(15,820 )
Cash and cash equivalents at beginning of period	74,471	60,519
Cash and cash equivalents at end of period	\$ 70,215	\$ 44,699
Supplemental cash flow information:		
Interest paid	\$ 1,118	\$ 1,152
Income taxes paid	\$ 91	\$ 28
Supplemental schedule of non-cash investing activities:		
Change in receivable for securities related to investment disposals that settled after the balance sheet date	\$ (2,169 )	\$ (8,191 )
Change in payable for securities related to investment purchases that settled after the balance sheet date	\$ 10,142	\$ 6,850

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 six business units that are supported by our insurance company subsidiaries. Our Standard Commercial business unit handles commercial insurance products and services in the standard market. Our Workers Compensation business unit specializes in small and middle market workers compensation business. Our E&S Commercial business unit handles primarily commercial and medical professional liability insurance products and services in the excess and surplus lines market. Our General Aviation business unit handles general aviation insurance products and services. Our Excess & Umbrella business 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 handles personal insurance products and services. Our insurance company subsidiaries supporting these operating units are American Hallmark Insurance Company of Texas (“AHIC”), Hallmark Insurance Company (“HIC”), Hallmark Specialty Insurance Company (“HSIC”), Hallmark County Mutual Insurance Company (“HCM”), Hallmark National Insurance Company (“HNIC”) and Texas Builders Insurance Company (“TBIC”).

These six business units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment includes the Standard Commercial business unit and the Workers Compensation business unit. 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, 2011 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of March 31, 2012 and 2011 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 March 31, 2012 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.")

### **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" under Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2011 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.

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

Restricted Cash : The carrying amount for restricted cash reported in the balance sheet approximates the fair value.

Revolving Credit Facility Payable: The carrying value of our bank revolving credit facility of \$1.6 million approximates the fair value based on the current interest rate.