

EMC INSURANCE GROUP INC

Form 10-Q

November 09, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended SEPTEMBER 30, 2006

OR

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

For the transition period from _____ to _____

Commission File Number: 0-10956

EMC INSURANCE GROUP INC.

(Exact name of registrant as specified in its charter)

Iowa

(State or other jurisdiction of
incorporation or organization)

42-6234555

(I.R.S. Employer
Identification No.)

717 Mulberry Street, Des Moines, Iowa

(Address of principal executive office)

50309

(Zip Code)

(515) 345-2902

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 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.

X Yes O No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

☐ Yes ☒ No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at October 31, 2006
Common stock, \$1.00 par value	13,724,522

Total pages 51

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PART I. FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****EMC INSURANCE GROUP INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

(Unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Investments:		
Fixed maturities:		
Securities held-to-maturity, at amortized cost (fair value \$5,805,809 and \$18,287,704)	\$ 5,695,970	\$ 17,927,478
Securities available-for-sale, at fair value (amortized cost \$707,695,887 and \$740,845,145)	718,800,670	753,399,943
Fixed maturity securities on loan:		
Securities held-to-maturity, at amortized cost (fair value \$0 and \$1,891,504)	-	1,866,928
Securities available-for-sale, at fair value (amortized cost \$74,223,300 and \$41,922,225)	73,659,615	41,656,150
Equity securities available-for-sale, at fair value (cost \$72,170,532 and \$66,115,755)	101,797,870	93,343,172
Other long-term investments, at cost	2,225,475	4,269,566
Short-term investments, at cost	54,989,851	37,345,456
Total investments	957,169,451	949,808,693
Balances resulting from related party transactions with Employers Mutual:		
Reinsurance receivables	39,007,606	46,372,087
Prepaid reinsurance premiums	5,509,531	4,846,084
Deferred policy acquisition costs	36,229,151	34,106,217
Defined benefit retirement plan, prepaid asset	3,887,091	5,633,370
Other assets	3,312,739	2,281,025
Indebtedness of related party	22,394,234	-
Cash	186,850	333,048
Accrued investment income	11,528,137	10,933,046
Accounts receivable (net of allowance for uncollectible accounts of \$0 and \$0)	262,687	211,595
Deferred income taxes	14,739,535	13,509,369
Goodwill, at cost less accumulated amortization of \$2,616,234 and \$2,616,234	941,586	941,586
Securities lending collateral	75,766,743	44,705,501

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Total assets	\$	1,170,935,341	\$	1,113,681,621
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See accompanying Notes to Interim Consolidated Financial Statements.

EMC INSURANCE GROUP INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	September 30, 2006	December 31, 2005
LIABILITIES		
Balances resulting from related party transactions with Employers Mutual:		
Losses and settlement expenses	\$ 538,608,680	\$ 544,051,061
Unearned premiums	171,244,923	160,693,288
Other policyholders' funds	6,910,301	5,359,116
Surplus notes payable	36,000,000	36,000,000
Indebtedness to related party	-	19,899,329
Employee retirement plans	14,984,145	13,681,388
Other liabilities	20,786,161	21,764,259
Income taxes payable	6,837,492	5,644,516
Securities lending obligation	75,766,743	44,705,501
Total liabilities	871,138,445	851,798,458
STOCKHOLDERS' EQUITY		
Common stock, \$1 par value, authorized 20,000,000 shares; issued and outstanding, 13,733,984 shares in 2006 and 13,642,705 shares in 2005	13,733,984	13,642,705
Additional paid-in capital	106,728,775	104,800,407
Accumulated other comprehensive income	25,894,031	25,470,039
Retained earnings	153,440,106	117,970,012
Total stockholders' equity	299,796,896	261,883,163
Total liabilities and stockholders' equity	\$ 1,170,935,341	\$ 1,113,681,621

See accompanying Notes to Interim Consolidated Financial Statements.

EMC INSURANCE GROUP INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

All balances presented below, with the exception of net investment income, realized investment gains (losses) and income tax expense (benefit), are the result of related party transactions with Employers Mutual.

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
REVENUES				
Premiums earned	\$ 95,149,396	\$ 103,414,289	\$ 288,859,515	\$ 308,910,568
Investment income, net	11,641,340	10,573,218	34,788,213	29,705,465
Realized investment gains (losses)	(1,021,377)	1,184,949	3,011,392	2,746,628
Other income	99,312	150,022	432,205	393,692
	105,868,671	115,322,478	327,091,325	341,756,353
LOSSES AND EXPENSES				
Losses and settlement expenses	55,839,336	69,590,738	164,369,163	205,977,422
Dividends to policyholders	3,885,873	2,414,677	6,617,016	4,756,749
Amortization of deferred policy acquisition costs	19,786,485	21,549,323	63,778,035	67,757,284
Other underwriting expenses	10,295,721	9,938,592	29,966,916	29,030,353
Interest expense	278,100	278,100	834,300	834,300
Other expense	454,925	339,832	1,533,378	1,254,352
	90,540,440	104,111,262	267,098,808	309,610,460
Income before income tax expense	15,328,231	11,211,216	59,992,517	32,145,893
INCOME TAX EXPENSE (BENEFIT)				
Current	4,535,291	3,583,112	19,398,138	10,868,949
Deferred	(181,524)	(700,617)	(1,458,470)	(2,715,031)
	4,353,767	2,882,495	17,939,668	8,153,918
Net income	\$ 10,974,464	\$ 8,328,721	\$ 42,052,849	\$ 23,991,975
Net income per common share				
-basic and diluted	\$ 0.80	\$ 0.61	\$ 3.07	\$ 1.76
Dividend per common share	\$ 0.16	\$ 0.15	\$ 0.48	\$ 0.45
Average number of common shares outstanding				
-basic and diluted	13,730,067	13,609,562	13,703,746	13,598,955

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See accompanying Notes to Interim Consolidated Financial Statements.

EMC INSURANCE GROUP INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Net income	\$ 10,974,464	\$ 8,328,721	\$ 42,052,849	\$ 23,991,975
OTHER COMPREHENSIVE INCOME				
Unrealized holding gains (losses) arising during the period, before deferred income tax expense (benefit)	17,827,894	(4,454,035)	3,663,688	1,256,773
Deferred income tax expense (benefit)	6,239,763	(1,558,911)	1,282,291	439,872
	11,588,131	(2,895,124)	2,381,397	816,901
Reclassification adjustment for (gains) losses included in net income, before income tax expense (benefit)	1,021,377	(1,184,949)	(3,011,392)	(2,746,628)
Income tax expense (benefit)	(357,482)	414,732	1,053,987	961,320
	663,895	(770,217)	(1,957,405)	(1,785,308)
Other comprehensive income (loss)	12,252,026	(3,665,341)	423,992	(968,407)
Total comprehensive income	\$ 23,226,490	\$ 4,663,380	\$ 42,476,841	\$ 23,023,568

See accompanying Notes to Interim Consolidated Financial Statements.

EMC INSURANCE GROUP INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine months ended September 30,	
	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 42,052,849	\$ 23,991,975
Adjustments to reconcile net income to net cash provided by operating activities:		
Balances resulting from related party transactions with Employers Mutual:		
Losses and settlement expenses	(5,442,381)	40,645,527
Unearned premiums	10,551,635	15,243,447
Other policyholders' funds	1,551,185	264,087
Indebtedness to related party	(42,293,563)	(34,628,207)
Employee retirement plans	3,049,036	2,686,949
Reinsurance receivables	7,364,481	(8,897,594)
Prepaid reinsurance premiums	(663,447)	(854,735)
Commission payable	(2,274,088)	(5,286,347)
Interest payable	(278,100)	(278,100)
Prepaid assets	(931,124)	(524,000)
Deferred policy acquisition costs	(2,122,934)	(3,235,264)
Other, net	1,473,500	1,180,579
Accrued investment income	(595,091)	(1,143,091)
Accrued income tax:		
Current	1,192,976	4,500,768
Deferred	(1,458,470)	(2,715,031)
Realized investments gains	(3,011,392)	(2,746,628)
Accounts receivable	(51,092)	(10,636)
Amortization of premium/discount on securities	577,744	731,871
	(33,361,125)	4,933,595
Cash provided by the change in the property and casualty insurance subsidiaries' pool participation percentage	-	107,801,259
Net cash provided by operating activities	\$ 8,691,724	\$ 136,726,829

EMC INSURANCE GROUP INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED

(Unaudited)

	Nine months ended September 30,	
	2006	2005
CASH FLOWS FROM INVESTING ACTIVITIES		
Maturities of fixed maturity securities held-to-maturity	\$ 14,084,574	\$ 9,287,629
Purchases of fixed maturity securities available-for-sale	(77,986,791)	(474,092,929)
Disposals of fixed maturity securities available-for-sale	78,733,073	335,442,043
Purchases of equity securities available-for-sale	(35,753,399)	(33,786,111)
Disposals of equity securities available-for-sale	32,248,033	32,966,439
Purchases of other long-term investments	(300,000)	(969,000)
Disposals of other long-term investments	2,344,091	2,178,642
Net purchases of short-term investments	(17,644,395)	(2,193,321)
Net cash used in investing activities	(4,274,814)	(131,166,608)
CASH FLOWS FROM FINANCING ACTIVITIES		
Balances resulting from related party transactions with Employers Mutual:		
Issuance of common stock through Employers Mutual's stock option plans	2,019,647	915,842
Dividends paid to Employers Mutual	(3,735,529)	(3,350,951)
Dividends paid to Employers Mutual (reimbursement for non-GAAP expense)	-	(172,520)
Dividends paid to public stockholders	(2,847,226)	(2,770,774)
Net cash used in financing activities	(4,563,108)	(5,378,403)
NET INCREASE (DECREASE) IN CASH	(146,198)	181,818
Cash at the beginning of the year	333,048	61,088
Cash at the end of the quarter	\$ 186,850	\$ 242,906

See accompanying Notes to Interim Consolidated Financial Statements.

EMC INSURANCE GROUP INC. AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared on the basis of U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the interim financial statements have been included. The results of operations for the interim periods reported are not necessarily indicative of results to be expected for the year.

The consolidated balance sheet at December 31, 2005 has been derived from the audited financial statements at that date, but does not include all of the information and notes required by GAAP for complete financial statements.

Certain amounts previously reported in prior years' consolidated financial statements have been reclassified to conform to current year presentation.

In reading these financial statements, reference should be made to the Company's 2005 Form 10-K or the 2005 Annual Report to Shareholders for more detailed footnote information.

2. QUOTA SHARE AGREEMENT

Effective January 1, 2006, the terms of the quota share agreement between Employers Mutual and the reinsurance subsidiary were revised. The majority of the changes were prompted by the significant amount of hurricane losses retained by Employers Mutual during the severe 2005 hurricane season; however, other changes were made to simplify and clarify the terms and conditions of the quota share agreement. The revised terms of the quota share agreement for 2006 are as follows: (1) the reinsurance subsidiary's retention, or cap, on losses assumed per event increased from \$1,500,000 to \$2,000,000; (2) the cost of the \$2,000,000 cap on losses assumed per event will be treated as a reduction to written premiums rather than commission expense; (3) the reinsurance subsidiary will no longer directly pay for the outside reinsurance protection that Employers Mutual purchases to protect itself from catastrophic losses on the assumed reinsurance business it retains in excess of the cap, and will instead pay a higher premium rate (previously accounted for as commission); and (4) the reinsurance subsidiary will assume all foreign currency exchange risk/benefit associated with contracts incepting on January 1, 2006 and thereafter that are subject to the quota share agreement. For 2006, the premium rate paid by the reinsurance subsidiary to Employers Mutual is 10.5 percent of written premiums. The corresponding rate for 2005 was approximately 8.5 percent (4.5 percent override commission rate plus approximately 4.0 percent for the cost of

the outside reinsurance protection).

EMC INSURANCE GROUP INC. AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited)

3. REINSURANCE

The effect of reinsurance on premiums written and earned, and losses and settlement expenses incurred, for the three months and nine months ended September 30, 2006 and 2005 is presented below.

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Premiums written				
Direct	\$ 60,258,600	\$ 56,596,926	\$ 148,110,663	\$ 147,313,971
Assumed from nonaffiliates	661,288	1,049,086	2,768,436	3,637,247
Assumed from affiliates	118,737,525	126,697,971	316,160,134	368,654,660
Ceded to nonaffiliates	(7,507,043)	(8,080,144)	(20,305,560)	(19,410,673)
Ceded to affiliates	(60,258,600)	(56,596,926)	(148,110,663)	(147,313,971)
Net premiums written	\$ 111,891,770	\$ 119,666,913	\$ 298,623,010	\$ 352,881,234
Premiums earned				
Direct	\$ 45,795,252	\$ 46,696,422	\$ 139,783,274	\$ 139,644,006
Assumed from nonaffiliates	676,425	1,240,133	2,980,602	3,520,634
Assumed from affiliates	101,156,124	109,356,926	305,521,032	322,927,257
Ceded to nonaffiliates	(6,683,153)	(7,182,770)	(19,642,119)	(17,537,323)
Ceded to affiliates	(45,795,252)	(46,696,422)	(139,783,274)	(139,644,006)
Net premiums earned	\$ 95,149,396	\$ 103,414,289	\$ 288,859,515	\$ 308,910,568
Losses and settlement expenses incurred				
Direct	\$ 25,240,778	\$ 44,955,313	\$ 65,641,078	\$ 113,132,998
Assumed from nonaffiliates	276,012	2,032,655	2,076,245	6,253,288
Assumed from affiliates	55,609,073	75,516,618	167,565,484	222,984,589
Ceded to nonaffiliates	(45,749)	(7,958,535)	(5,272,566)	(23,260,455)
Ceded to affiliates	(25,240,778)	(44,955,313)	(65,641,078)	(113,132,998)
Net losses and settlement expenses incurred	\$ 55,839,336	\$ 69,590,738	\$ 164,369,163	\$ 205,977,422

For 2006, premiums written and earned assumed from affiliates, and losses and settlement expenses incurred assumed from affiliates, reflect a reduction in Employers Mutual's participation in the Mutual Reinsurance Bureau (MRB) pool. The board of directors of the MRB pool approved the admission of Kentucky Farm Bureau Mutual and Country Mutual Insurance Company as new assuming companies to the pool effective January 1, 2006. This reduced Employers Mutual's participation in the pool from a one-third share to an approximate one-fifth share (Country Mutual is only assuming property exposures). The premiums written assumed from affiliates and net premiums written amounts for the nine

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months ended September 30, 2006 also include a negative \$3,440,024 portfolio adjustment related to this change in participation.

In 2005, the Company's aggregate participation interest in the pooling agreement increased from 23.5 percent to 30.0 percent. The premiums written assumed from affiliates and net premiums written amounts for the nine months ended September 30, 2005 include a \$29,630,612 portfolio adjustment increase related to this change in pool participation.

EMC INSURANCE GROUP INC. AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited)

4. STOCK BASED COMPENSATION

The Company has no stock based compensation plans of its own; however, Employers Mutual has several stock plans which utilize the common stock of the Company. Employers Mutual can provide the common stock required under its plans by: 1) using shares of common stock that it currently owns; 2) purchasing common stock on the open market; or 3) directly purchasing common stock from the Company at the current fair value. Employers Mutual has historically purchased common stock from the Company for use in its incentive stock option plans.

Employers Mutual maintains two separate stock option plans for the benefit of officers and key employees of Employers Mutual and its subsidiaries. A total of 1,000,000 shares have been reserved for issuance under the 1993 Employers Mutual Casualty Company Incentive Stock Option Plan (1993 Plan) and a total of 1,500,000 shares of the Company's common stock have been reserved for the 2003 Employers Mutual Casualty Company Incentive Stock Option Plan (2003 Plan).

There is a ten year time limit for granting options under the plans. Options can no longer be granted under the 1993 Plan. Options granted under the plans have a vesting (requisite service) period of two, three, four or five years with options becoming exercisable in equal annual cumulative increments. Option prices cannot be less than the fair value of the stock on the date of grant.

The Senior Executive Compensation and Stock Option Committee (the Committee) of Employers Mutual's Board of Directors (the Board) grants the options and is the administrator of the plans. In 2004, the Company's Board of Directors established its own Compensation Committee (the Company Compensation Committee) and, commencing in 2005, the Company Compensation Committee considered and approved all stock options granted to the Company's executive officers.

Under the terms of the pooling and quota share agreements, stock option expense is allocated to the Company's insurance subsidiaries as determined on a statutory basis of accounting. The Company's insurance subsidiaries reimburse Employers Mutual for their share of the statutory-basis compensation expense (equal to the excess of the fair value of the stock over the option's exercise price) associated with stock option exercises.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004) Share-Based Payment, which is a revision of SFAS No. 123 (as amended by SFAS 148) Accounting for Stock-Based Compensation and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Effective January 1, 2006, the Company adopted SFAS 123(R) using the modified prospective method, which requires compensation expense to be recorded for all options granted after the date of adoption as well as for existing options for which the requisite service has not been rendered as of the date of adoption. The modified-prospective method does not require restatement of prior periods to reflect the impact of

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SFAS 123(R). There was no initial change to net income or total stockholders' equity upon the adoption of SFAS 123(R). As a result of adopting SFAS 123(R), the Company recognized compensation expense of \$42,362 and \$139,733 (gross and net of tax) for the three months and nine months ended September 30, 2006.

Prior to January 1, 2006, under the provisions of APB 25, the Company did not recognize any compensation expense from the operation of Employers Mutual's stock option plans since the exercise price of the options was equal to the fair value of the stock on the date of grant. The statutory-basis compensation expense that was paid by the Company's subsidiaries to Employers Mutual (\$36,495 and \$172,520 for the three months and nine months ended September 30, 2005) was reclassified as a dividend payment to Employers Mutual in these GAAP-basis financial statements.

EMC INSURANCE GROUP INC. AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited)

The following table illustrates the effect on net income and net income per share for the three months and nine months ended September 30, 2005 if the Company had applied the fair value recognition provisions of SFAS 123 (as amended by SFAS 148) Accounting for Stock-Based Compensation to Employers Mutual's stock option plans:

	Three months ended September 30, 2005	Nine months ended September 30, 2005
Net income, as reported	\$ 8,328,721	\$ 23,991,975
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards vesting in the current calendar year	29,398	