MEADOWBROOK INSURANCE GROUP INC
Form 10-Q
November 09, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549

Form 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarter ended September 30, 2007

or

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

Commission File Number 1-14094

Meadowbrook Insurance Group, Inc.
(Exact name of Registrant as specified in its charter)

Michigan	**38-2626206**
(State of Incorporation)	*(IRS Employer Identification No.)*

26255 American Drive,
Southfield, Michigan 48034
(Address, zip code of principal executive offices)

(248) 358-1100
(Registrant s telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (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 þ No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

The aggregate number of shares of the Registrant s Common Stock, $.01 par value, outstanding on November 1, 2007 was 36,980,439.

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PART 1 FINANCIAL INFORMATION

ITEM 1 *FINANCIAL STATEMENTS*

MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF INCOME
For the Nine Months Ended September 30,

	2007	2006
	(Unaudited) (In thousands, except share data)	
Revenues		
Premiums earned		
Gross	$ 251,605	$ 244,557
Ceded	(51,873)	(53,231)
Net earned premiums	199,732	191,326
Net commissions and fees	35,613	31,599
Net investment income	19,173	16,203
Net realized (losses) gains	(186)	46
Total revenues	254,332	239,174
Expenses		
Losses and loss adjustment expenses	144,880	160,066
Reinsurance recoveries	(31,512)	(49,748)
Net losses and loss adjustment expenses	113,368	110,318
Salaries and employee benefits	42,181	41,397
Policy acquisition and other underwriting expenses	39,739	37,663
Other administrative expenses	23,882	21,694
Amortization expense	1,309	448
Interest expense	4,631	4,445
Total expenses	225,110	215,965
Income before taxes and equity earnings	29,222	23,209
Federal and state income tax expense	8,829	7,215
Equity earnings of affiliates	271	99
Net income	$ 20,664	$ 16,093
Earnings Per Share		

Basic	$	0.65	$	0.56
Diluted	$	0.65	$	0.55
Weighted average number of common shares				
Basic		31,666,032		28,894,053
Diluted		31,761,244		29,509,892

The accompanying notes are an integral part of the Consolidated Financial Statements.

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MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF INCOME
For the Three Months Ended September 30,

	2007	2006
	(Unaudited) (In thousands, except share data)	
Revenues		
Premiums earned		
Gross	$ 84,791	$ 81,164
Ceded	(17,454)	(17,476)
Net earned premiums	67,337	63,688
Net commissions and fees	13,319	9,612
Net investment income	6,788	5,584
Net realized (losses) gains	(200)	28
Total revenues	87,244	78,912
Expenses		
Losses and loss adjustment expenses	43,498	52,247
Reinsurance recoveries	(6,483)	(16,118)
Net losses and loss adjustment expenses	37,015	36,129
Salaries and employee benefits	15,750	14,183
Policy acquisition and other underwriting expenses	12,927	13,059
Other administrative expenses	8,890	6,767
Amortization expense	622	141
Interest expense	1,476	1,558
Total expenses	76,680	71,837
Income before taxes and equity earnings	10,564	7,075
Federal and state income tax expense	3,219	2,056
Equity earnings of affiliates	210	74
Net income	$ 7,555	$ 5,093
Earnings Per Share		
Basic	$ 0.21	$ 0.18
Diluted	$ 0.21	$ 0.17
Weighted average number of common shares		
Basic	35,293,796	28,884,578
Diluted	35,378,119	29,498,596

The accompanying notes are an integral part of the Consolidated Financial Statements.

MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Nine Months Ended September 30,

	2007	2006
	(Unaudited) (In thousands)	
Net income	$ 20,664	$ 16,093
Other comprehensive income, net of tax:		
Unrealized gains on securities	344	379
Net deferred derivative (loss) gain hedging activity	(176)	109
Less: reclassification adjustment for gains included in net income	19	19
Other comprehensive income, net of tax	187	507
Comprehensive income	$ 20,851	$ 16,600

MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Three Months Ended September 30,

	2007	2006
	(Unaudited) (In thousands)	
Net income	$ 7,555	$ 5,093
Other comprehensive income, net of tax:		
Unrealized gains on securities	4,520	5,624
Net deferred derivative losses hedging activity	(289)	(322)
Less: reclassification adjustment for losses included in net income	(2)	
Other comprehensive income, net of tax	4,229	5,302
Comprehensive income	$ 11,784	$ 10,395

The accompanying notes are an integral part of the Consolidated Financial Statements.

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MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED BALANCE SHEETS

	September 30, 2007 (Unaudited)	December 31, 2006
	(In thousands, except share data)	
ASSETS		
Investments		
Debt securities available for sale, at fair value (amortized cost of $564,998 and $486,213)	$ 564,070	$ 484,724
Cash and cash equivalents	49,792	42,876
Accrued investment income	6,539	5,884
Premiums and agent balances receivable, net	102,590	85,578
Reinsurance recoverable on:		
Paid losses	2,665	4,257
Unpaid losses	195,313	198,422
Prepaid reinsurance premiums	15,941	20,425
Deferred policy acquisition costs	27,787	27,902
Deferred federal income taxes	16,688	15,732
Goodwill	43,497	31,502
Other assets	59,012	51,698
Total assets	$ 1,083,894	$ 969,000
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities		
Losses and loss adjustment expenses	$ 528,985	$ 501,077
Unearned premiums	151,203	144,575
Debt		7,000
Debentures	55,930	55,930
Accounts payable and accrued expenses	24,810	25,384
Reinsurance funds held and balances payable	12,805	15,124
Payable to insurance companies	5,832	5,442
Other liabilities	14,101	12,775
Total liabilities	793,666	767,307
Shareholders Equity		
Common stock, $0.01 stated value; authorized 75,000,000 shares; 36,980,070 and 29,107,818 shares issued and outstanding	370	291
Additional paid-in capital	194,431	126,828
Retained earnings	96,947	76,282
Note receivable from officer	(870)	(871)

Accumulated other comprehensive loss	(650)	(837)
Total shareholders equity	290,228	201,693
Total liabilities and shareholders equity	$ 1,083,894	$ 969,000

The accompanying notes are an integral part of the Consolidated Financial Statements.

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MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30,

	2007	2006
	(Unaudited)	
	(In thousands)	
Cash Flows From Operating Activities		
Net income	$ 20,664	$ 16,093
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of other intangible assets	1,309	448
Amortization of deferred debenture issuance costs	236	177
Depreciation of furniture, equipment, and building	2,280	1,761
Net accretion of discount and premiums on bonds	2,031	1,947
Loss on sale of investments, net	30	30
Gain on sale of fixed assets	(66)	(66)
Stock-based employee compensation	2	118
Incremental tax benefits from stock options exercised	(656)	(1,386)
Long-term incentive plan expense	596	704
Deferred income tax expense	(1,058)	540
Changes in operating assets and liabilities:		
Decrease (increase) in:		
Premiums and agent balances receivable	(13,138)	(21,753)
Reinsurance recoverable on paid and unpaid losses	4,701	1,160
Prepaid reinsurance premiums	4,484	1,623
Deferred policy acquisition costs	115	(747)
Other assets	686	(1,532)
Increase (decrease) in:		
Losses and loss adjustment expenses	27,907	34,963
Unearned premiums	6,628	4,541
Payable to insurance companies	390	(2,838)
Reinsurance funds held and balances payable	(2,318)	5,186
Other liabilities	(2,599)	2,008
Total adjustments	31,560	26,884
Net cash provided by operating activities	52,224	42,977
Cash Flows From Investing Activities		
Purchase of debt securities available for sale	(293,932)	(156,015)
Proceeds from sales and maturities of debt securities available for sale	213,633	80,182
Capital expenditures	(2,289)	(3,790)
Purchase of books of business	(75)	(133)
Acquisition of U.S Specialty Underwriters, Inc.	(12,644)	
Other investing activities	(110)	300

Net cash used in investing activities		(95,417)		(79,456)
Cash Flows From Financing Activities				
Proceeds from lines of credit		19,025		12,578
Payment of lines of credit		(26,025)		(9,878)
Book overdraft		218		23
Stock options exercised		(315)		(716)
Cash payment for payroll taxes associated with long-term incentive plan net stock issuance		(1,841)		
Incremental tax benefits from stock options exercised		656		1,386
Net proceeds received from public equity offering		58,585		
Other financing activities		(194)		(207)
Net cash provided by financing activities		50,109		3,186
Net increase (decrease) in cash and cash equivalents		6,916		(33,293)
Cash and cash equivalents, beginning of period		42,876		58,038
Cash and cash equivalents, end of period	$	49,792	$	24,745
Supplemental Disclosure of Non-Cash Investing and Financing Activities:				
Common stock portion of purchase price for acquisition of U.S. Specialty Underwriters, Inc.	$	10,000	$	

The accompanying notes are an integral part of the Consolidated Financial Statements.

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MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 Summary of Significant Accounting Policies

Basis of Presentation and Management Representation

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 are collectively referred to as the Insurance Company Subsidiaries), and Preferred Insurance Company, Ltd. The consolidated financial statements also include Meadowbrook, Inc., Crest Financial Corporation, and their subsidiaries.

Pursuant to Financial Accounting Standards Board Interpretation Number (FIN) 46(R), the Company does not consolidate its subsidiaries, Meadowbrook Capital Trust I and II (the Trusts), as they are not variable interest entities and the Company is not the primary beneficiary of the Trusts. The consolidated financial statements, however, include the equity earnings of the Trusts. In addition and in accordance with FIN 46(R), the Company does not consolidate its subsidiary American Indemnity Insurance Company, Ltd. (American Indemnity). While the Company and its subsidiary Star are the common shareholders, they are not the primary beneficiaries of American Indemnity. The consolidated financial statements, however, include the equity earnings of American Indemnity.

In the opinion of management, the consolidated financial statements reflect all normal recurring adjustments necessary to present a fair statement of the results for the interim period. Preparation of financial statements under generally accepted accounting principles requires management to make estimates. Actual results could differ from those estimates. The results of operations for the three months and nine months ended September 30, 2007, are not necessarily indicative of the results expected for the full year.

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, as filed with the United States Securities and Exchange Commission, for the year ended December 31, 2006.

The Company s consolidated statement of comprehensive income for the three months and nine months ended September 30, 2006, previously reported, had a computational error. Comprehensive income for the nine months ended September 30, 2006, was immaterially overstated by $118,000. Comprehensive income for the three months ended September 30, 2006, was understated by $322,000. The consolidated statements of comprehensive income for 2007 for the 2006 comparative periods have been restated for this computational error.

The Company s Note 8 *Segment Information* of the Notes to Consolidated Financial Statements for the three months and nine months ended September 30, 2006, previously reported, had a change in allocation. The agency operations of the Company s segment information include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The Company s agency Insurance & Benefits Consultants allocation was previously included in specialty risk management operations. The effect of this reclassification was a reduction in agency operations and an increase in specialty risk management operations pre-tax income for the three months and nine months ended September 30, 2006 of $250,000 and $102,000, respectively. The Company s Note 8 *Segment Information* has been restated to reflect this reclassification.

Revenue Recognition

Premiums written, which include direct, assumed, and ceded 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 and actuarial estimates.

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MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the nine months ending September 30, 2007, total assumed written premiums were $36.9 million, of which $31.3 million relates to assumed business the Company manages directly, and therefore, no estimation is involved. The remaining $5.6 million of assumed written premiums relates to residual markets and mandatory assumed pool business.

For the three months ending September 30, 2007, total assumed written premiums were $3.8 million, of which $1.7 million relates to assumed business the Company manages directly. The remaining $2.1 million of assumed written premiums relates to residual markets and mandatory assumed pool business.

Assumed premium estimates are specifically related to the mandatory assumed pool business from the National Council on Compensation Insurance (NCCI), or residual market business. The pool cedes workers compensation business to participating companies based upon the individual company s market share by state. The activity is reported from the NCCI to participating companies on a two quarter lag. To accommodate this lag, the Company estimates premium and loss activity based on historical and market based results. Historically, the Company has not experienced any material difficulties or disputes in collecting balances from NCCI; and therefore, no provision for doubtful accounts is recorded related to the assumed premium estimate.

In addition, certain premiums are subject to retrospective premium adjustments. Premium is recognized over the term of the insurance contract.

Fee income, which includes risk management consulting, loss control, and claims services, is recognized during the period the services are provided. Depending on the terms of the contract, claims processing fees are recognized as revenue over the estimated life of the claims, or the estimated life of the contract. For those contracts that provide services beyond the expiration or termination of the contract, fees are deferred in an amount equal to management s estimate of the Company s obligation to continue to provide services.

Commission income, which includes reinsurance placement, is recorded on the later of the effective date or the billing date of the policies on which they were earned. Commission income is reported net of any sub-producer commission expense. Any commission adjustments that occur subsequent to the earnings process are recognized upon notification from the insurance companies. Profit sharing commissions from insurance companies are recognized when determinable, which is when such commissions are received.

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

Outstanding options of 98,807 and 125,221 for the nine months ended September 30, 2007 and 2006, 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 31,967 and 147,201 for the nine months ended September 30, 2007 and 2006, respectively. Shares related to the Company s Long Term Incentive Plan (LTIP) included in diluted earnings per share were 63,245 and 468,636 for the nine months ended September 30, 2007 and 2006, respectively.

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Outstanding options of 98,807 and 125,221 for the three months ended September 30, 2007 and 2006, 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 30,995 and 162,460 for the three months ended September 30, 2007 and 2006, respectively. Shares related to the Company s LTIP included in diluted earnings per share were 53,328 and 451,559 for the three months ended September 30, 2007 and 2006, respectively.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements,* which becomes effective for fiscal years beginning after November 15, 2007. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The Company is in the process of evaluating the impact of SFAS No. 157, but believes the adoption of SFAS No. 157 will not have a material impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115.* SFAS No. 159 will permit entities the option to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis as of specified election dates. This election is irrevocable. The objective of SFAS No. 159 is to improve financial reporting and reduce the volatility in reported earnings caused by measuring related assets and liabilities differently. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is in the process of evaluating the potential impact SFAS No. 159 will have on its consolidated financial statements.

NOTE 2 Stock Options, Long Term Incentive Plan, and Deferred Compensation Plan

Stock Options

Effective January 1, 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment,* using the modified prospective application transition method. The Company previously adopted the requirements of recording stock options consistent with SFAS 123 and accounting for the change in accounting principle using the prospective method in accordance with SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123.* Under the prospective method, stock-based compensation expense was recognized for awards granted after the beginning of the fiscal year in which the change is made, or January 1, 2003. Upon implementation of SFAS No. 148 in 2003, the Company recognized stock-based compensation expense for awards granted after January 1, 2003.

Prior to the adoption of SFAS No. 148, the Company applied the intrinsic value-based provisions set forth in APB Opinion No. 25. Under the intrinsic value method, compensation expense is determined on the measurement date, which is the first date when both the number of shares the employee is entitled to receive, and the exercise price are known. Compensation expense, if any, resulting from stock options granted by the Company was determined based upon the difference between the exercise price and the fair market value of the underlying common stock at the date of grant. The Company s Stock Option Plan requires the exercise price of the grants to be at the current fair market value of the underlying common stock.

Upon adoption of SFAS No. 123(R), the Company was required to recognize as an expense in the financial statements all share-based payments to employees based on their fair values. SFAS No. 123(R) requires forfeitures to be estimated in calculating the expense relating to the share-based payments, as opposed to recognizing any forfeitures and the corresponding reduction in expense as they occur. In addition, SFAS No. 123(R) requires any tax savings resulting from tax deductions in excess of compensation expense be reflected in the financial statements as a cash inflow from financing activities, rather than as an operating cash flow as in prior periods. The pro forma disclosures previously permitted under SFAS 123, are no longer an alternative to financial statement recognition. As indicated, the Company adopted the requirements of SFAS 123(R) using the modified prospective application

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MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

transition method. The prospective method requires compensation expense to be recorded for all unvested stock options and restricted stock, based upon the previously disclosed SFAS 123 methodology and amounts.

The Company, through its 1995 and 2002 Amended and Restated 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. The Company has not issued any new stock options to employees since 2003.

The following is a summary of the Company s stock option activity and related information for the nine months ended September 30, 2007:

	Options	Weighted-Average Exercise Price
Outstanding as of December 31, 2006	391,678	$ 7.38
Exercised	(214,644)	$ 2.71
Forfeited	(15,052)	$ 21.68
Outstanding as of September 30, 2007	161,982	$ 12.23
Exercisable as of September 30, 2007	136,112	$ 12.11

The following table summarizes information about stock options outstanding at September 30, 2007:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	**Options**	**Weighted-Average Remaining Life (Years)**	**Weighted-Average Exercise Price**	**Options**	**Weighted-Average Exercise Price**
$2.173 to $3.507	61,675	0.9	$ 2.17	61,675	$ 2.17
$6.48	1,500	2.7	$ 6.48	1,000	$ 3.24
$10.91 to $24.6875	98,807	1.2	$ 18.60	73,437	$ 23.47
	161,982	1.1	$ 12.23	136,112	$ 12.11

Compensation expense of $2,000 and $118,000 has been recorded in the nine months ended September 30, 2007 and 2006 under SFAS 123(R), respectively. Compensation expense of $3,400 has been recorded in the three months ended September 30, 2006 under SFAS 123(R). As of March 31, 2007, the Company has fully expensed all of its current outstanding stock options.

Long Term Incentive Plan

In 2004, the Company adopted a Long Term Incentive Plan (the LTIP). The LTIP provides participants with the opportunity to earn cash and stock awards based upon the achievement of specified financial goals over a three-year performance period with the first performance period commencing January 1, 2004. At the end of a three-year performance period, and if the performance targets for that period are achieved, the Compensation Committee of the Board of Directors shall determine the amount of LTIP awards that are payable to participants in the LTIP for the current performance period. One-half of any LTIP award will be payable in cash and one-half of the award will be payable in the form of a stock award. If the Company achieves the performance targets for the three-year performance period, payment of the cash portion of the award would be made in three annual installments, with the first payment being paid as of the end of the that performance period and the remaining two payments to be paid in

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the subsequent two years. Any unpaid portion of a cash award is subject to forfeiture if the participant voluntarily leaves the Company or is discharged for cause. The portion of the award to be paid in the form of stock will be issued as of the end of that performance period. The number of shares of Company s common stock subject to the stock award shall equal the dollar amount of one-half of the LTIP award divided by the fair market value of Company s common stock on the first date of the beginning of the performance period. The stock awards shall be made subject to the terms and conditions of the LTIP and Plans. The Company accrues awards based upon the criteria set-forth and approved by the Compensation Committee of the Board of Directors, as included in the LTIP.

In 2006, the Company achieved its specified financial goals for the 2004-2006 plan years. On February 8, 2007, the Company s Board of Directors and the Compensation Committee of the Board of Directors approved the distribution of the LTIP award for the 2004-2006 plan years, which included both a cash and stock award. The total cash distribution was $2.5 million, of which $823,000 was paid out in 2007 with the remainder to be paid out in 2008 and 2009. The stock portion of the LTIP award was valued at $2.5 million, which resulted in the issuance of 579,496 shares of the Company s common stock. Of the 579,496 shares issued, 191,570 shares were retired for payment of the participant s associated withholding taxes related to the compensation recognized by the participant. The stock portion of the award was fully expensed as of December 31, 2006. The cash portion of the award is being expensed over a five-year period.

In addition, the Company s Board of Directors and the Compensation Committee of the Board of Directors approved the new performance targets for the 2007-2009 plan years. The Company commenced accruing for the LTIP payout for the 2007-2009 plan years as of March 31, 2007.

At September 30, 2007, the Company had $1.4 million and $596,000 accrued for the cash and stock award, respectively, for all plan years under the LTIP. Of the $1.4 million accrued for the cash award, $1.0 million relates to the 2004-2006 plan years and the remainder relates to the 2007-2009 plan years. As previously indicated, the stock portion for the 2004-2006 plan years was fully expensed as of December 31, 2006, thus the $596,000 stock award accrual relates to the 2007-2009 plan years. At December 31, 2006, the Company had $1.4 million and $2.5 million accrued for the cash and stock award, respectively. Shares related to the Company s LTIP included in diluted earnings per share were 63,245 and 468,636 for the nine months ended September 30, 2007 and 2006, respectively. For the three months ended September 30, 2007 and 2006, shares included in diluted earnings per share were 53,328 and 451,559, respectively.

Deferred Compensation Plan

In 2006, the Company adopted an Executive Nonqualified Excess Plan (the Excess Plan). The Excess Plan is intended to be a nonqualified deferred compensation plan that will comply with the provisions of Section 409A of the Internal Revenue Code. The Company adopted the Excess Plan to provide a means by which certain key management employees may elect to defer receipt of current compensation from the Company in order to provide retirement and other benefits, as provided for in the Excess Plan. In accordance with the Excess Plan, the assets of the Excess Plan are held in a rabbi trust. The Excess Plan is intended to be an unfunded plan maintained primarily for the purpose of providing deferred compensation benefits for eligible employees. At September 30, 2007 and December 31, 2006, the Company had $611,000 and $211,000 accrued for deferred compensation, respectively.

NOTE 3 Reinsurance

The Insurance Company Subsidiaries cede insurance to reinsurers 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 amounts. Therefore, the Company is subject to 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

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

monitors the economic characteristics of the reinsurers on an ongoing basis. The Company also assumes insurance from other domestic insurers and reinsurers. Based upon management s evaluation, they have concluded the reinsurance agreements entered into by the Company transfer both significant timing and underwriting risk to the reinsurer and, accordingly, are accounted for as reinsurance under the provisions of SFAS No. 113 Accounting and Reporting for Reinsurance for Short-Duration and Long-Duration Contracts.

Intercompany pooling agreements are commonly entered into between affiliated insurance companies, so as to allow the companies to utilize the capital and surplus of all of the companies, rather than each individual company. Under pooling arrangements, companies share in the insurance business that is underwritten and allocate the combined premium, losses and related expenses between the companies within the pooling arrangement. The Insurance Company Subsidiaries utilize an Inter-Company Reinsurance Agreement (the Pooling Agreement). This Pooling Agreement includes Star, Ameritrust Insurance Corporation (Ameritrust), Savers Property and Casualty Insurance Company (Savers) and Williamsburg National Insurance Company (Williamsburg). Pursuant to the Pooling Agreement, Savers, Ameritrust and Williamsburg have agreed to cede to Star and Star has agreed to reinsure 100% of the liabilities and expenses of Savers, Ameritrust and Williamsburg, relating to all insurance and reinsurance policies issued by them. In return, Star agreed to cede and Savers, Ameritrust and Williamsburg have agreed to reinsure Star for their respective percentages of the liabilities and expenses of Star. Annually, the Company examines the Pooling Agreement for any changes to the ceded percentage for the liabilities and expenses. Any changes to the Pooling Agreement must be submitted to the applicable regulatory authorities for approval.

At September 30, 2007 and December 31, 2006, the Company had reinsurance recoverables for paid and unpaid losses of $198.0 million and $202.7 million, respectively.

In regard to the Company s excess-of-loss reinsurance, the Company manages its credit risk on reinsurance recoverables by reviewing the financial stability, A.M. Best rating, capitalization, and credit worthiness of prospective and existing risk-sharing partners. The Company generally does not seek collateral where the reinsurer is rated A− or better by A.M. Best, has $500 million or more in surplus, and is admitted in the state of Michigan. As of September 30, 2007, the largest unsecured reinsurance recoverable is due from an admitted reinsurer with an A A.M. Best rating and accounts for 43.6% of the total recoverable for paid and unpaid losses.

In regard to the Company s risk-sharing partners (client captive or rent-a-captive quota-share non-admitted reinsurers), the Company manages credit risk on reinsurance recoverables by reviewing the financial stability, capitalization, and credit worthiness of prospective or existing reinsurers or partners. The Company customarily collateralizes reinsurance balances due from non-admitted reinsurers through funds withheld trusts or stand-by letters of credit issued by highly rated banks.

To date, the Company has not, in the aggregate, experienced material difficulties in collecting reinsurance recoverables.

The Company has historically maintained an allowance for the potential exposure to uncollectibility of certain reinsurance balances. At the end of each quarter, an analysis of these exposures is conducted to determine the potential exposure to uncollectibility. The following table sets forth the Company s exposure to uncollectible reinsurance and related allowances as of September 30, 2007 and December 31, 2006 (in thousands):

	September 30, 2007			December 31, 2006		
	Non Risk Sharing(1)	Risk Sharing(2)	Total	Non Risk Sharing(1)	Risk Sharing(2)	Total
Gross exposure	$ 6,722	$ 8,998	$ 15,720	$ 6,863	$ 7,952	$ 14,815
Collateral or other security	(13)	(4,849)	(4,862)	(170)	(3,453)	(3,623)
Allowance	(6,636)	(2,982)	(9,618)	(6,693)	(3,038)	(9,731)
Net exposure	$ 73	$ 1,167	$ 1,240	$	$ 1,461	$ 1,461

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(1) Balances related to three unaffiliated insurance companies, which are under regulatory liquidation or control, for which allowances have been established; all other admitted reinsurers have an A.M. Best rating of A− or better.

(2) Balances related to risk-sharing partners, which have either captive or rent-a-captive quota-share reinsurance contracts with the Company.

While management believes the above allowances to be adequate, no assurance can be given, however, regarding the future ability of any of the Company s risk-sharing partners to meet their financial obligations.

The Company maintains an excess-of-loss reinsurance treaty designed to protect against large or unusual loss and loss adjustment expense activity. The Company determines the appropriate amount of reinsurance primarily based on the Company s evaluation of the risks accepted, but also considers 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 treaty, reinsurers are responsible for 100% of each loss in excess of $350,000, up to $5.0 million for each claimant, on losses occurring prior to April 1, 2005. The Company increased its retention from $350,000 to $750,000, for losses occurring on or after April 1, 2005 and to $1.0 million for losses occurring on or after April 1, 2006. In addition, there is coverage for loss events involving more than one claimant up to $50.0 million per occurrence in excess of retentions of $1.0 million. In a loss event involving more than one claimant, the per claimant coverage is $10.0 million in excess of retentions of $1.0 million.

Under the core liability reinsurance treaty, the reinsurers are responsible for 100% of each loss in excess of $350,000, up to $2.0 million per occurrence on policies effective prior to June 1, 2005. The Company increased its retention from $350,000 to $500,000, for losses occurring on policies effective on or after June 1, 2005. The Company also purchased an additional $3.0 million of reinsurance clash coverage in excess of the $2.0 million to cover amounts that may be in excess of the $2.0 million policy limit, such as expenses associated with the settlement of claims or awards in excess of policy limits. Reinsurance clash coverage reinsures a loss when two or more policies are involved in a common occurrence. Effective June 1, 2006, the Company purchased a $5.0 million excess cover to support its umbrella business. This business had previously been reinsured through various semi-automatic agreements and will now be protected by one common treaty. The Company has no retention when the umbrella limit is in excess of the primary limit, but does warrant it will maintain a minimum liability of $1.0 million if the primary limit does not respond or is exhausted.

The Company has a separate treaty to cover liability specifically related to commercial trucking, where reinsurers are responsible for 100% of each loss in excess of $350,000, up to $1.0 million for losses occurring prior to December 1, 2005. The Company increased its retention from $350,000 to $500,000 for losses occurring on or after December 1, 2005. In addition, the Company purchased an additional $1.0 million of reinsurance clash coverage. The Company established a separate treaty to cover liability related to chemical distributors and repackagers, where reinsurers are responsible for 100% of each loss in excess of $500,000, up to $1.0 million, applied separately to general liability and auto liability. This treaty was terminated on a run-off basis on August 1, 2006. The exposures are covered under the core casualty treaty for policies effective August 1, 2006 and after. Additionally, the Company has a separate treaty

structure to cover liability related to agricultural business. The reinsurer is responsible for 100% of each loss in excess of $500,000, up to $1.0 million for casualty losses and up to $5.0 million, for property losses occurring on or after May 1, 2006. This treaty also provides an additional $1.0 million of reinsurance clash coverage for the casualty lines.

Under the property reinsurance treaty, reinsurers are responsible for 100% of the amount of each loss in excess of $500,000, up to $5.0 million per location. In addition, there is coverage for loss events involving multiple locations up to $20.0 million after the Company has incurred $750,000 in loss.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On May 1, 2007, the Company renewed its existing reinsurance agreement that provides reinsurance coverage for policies written in the Company s public entity excess liability program. The agreement provides reinsurance coverage of $4.0 million in excess of $1.0 million for each occurrence in excess of the policyholder s self-insured retention.

In addition, the Company renewed its reinsurance agreement that provides $10.0 million in excess of $5.0 million for each occurrence, which is above the underlying $5.0 million of coverage for the Company s public entity excess liability program. Under this agreement, reinsurers are responsible for 100% of each loss in excess of $5.0 million for all lines, except workers compensation, which is covered by the Company s core catastrophic workers compensation treaty structure up to $50.0 million per occurrence.

Additionally, certain small programs have separate reinsurance treaties in place, which limit the Company s exposure to $350,000 or less.

Facultative reinsurance is purchased for property values in excess of $5.0 million, casualty limits in excess of $2.0 million, or for coverage not covered by a treaty.

NOTE 4 Debt

Lines of Credit

In April 2007, the Company executed an amendment to its current revolving credit agreement with its bank. The amendments included an extension of the term to September 30, 2010, an increase to the available borrowings up to $35.0 million, and a reduction of the variable interest rate basis to a range between 75 to 175 basis points above LIBOR. The Company uses the revolving line of credit to meet short-term working capital needs. Under the revolving line of credit, the Company and certain of its non-regulated subsidiaries pledged security interests in certain property and assets of the Company and named subsidiaries.

At September 30, 2007, the Company did not have an outstanding balance on the revolving line of credit. In July 2007, the Company completed a secondary equity offering in which it received net proceeds of approximately $58.6 million. Upon receipt of the net proceeds, the Company reduced its outstanding line of credit balance from $22.0 million to zero. At December 31, 2006, the Company had an outstanding balance of $7.0 million on the revolving line of credit.

The revolving line of credit provides for interest at a variable rate based, at the Company s option, upon either a prime based rate or LIBOR-based rate. In addition, the revolving line of credit also provides for an unused facility fee. On prime based borrowings, the applicable margin ranges from 75 to 25 basis points below prime. On LIBOR-based borrowings, the applicable margin ranges from 75 to 175 basis points above LIBOR. The margin for all loans is dependent on the sum of non-regulated earnings before interest, taxes, depreciation, amortization, and non-cash impairment charges related to intangible assets for the preceding four quarters, plus dividends paid or payable to the Company from subsidiaries during such period (Adjusted EBITDA).

Debt covenants consist of: (1) maintenance of the ratio of Adjusted EBITDA to interest expense of 2.0 to 1.0, (2) minimum net worth of $130.0 million and increasing annually commencing June 30, 2005, by fifty percent of the prior year s positive net income, (3) minimum A.M. Best rating of B , and (4) minimum Risk Based Capital Ratio for

Star of 1.75 to 1.00. As of September 30, 2007, the Company was in compliance with these covenants.

Senior Debentures

In April 2004, the Company issued senior debentures in the amount of $13.0 million. The senior debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.0%, which is non-deferrable. At September 30, 2007, the interest rate was 9.56%. The senior debentures are callable by the Company at par after five years from the date of issuance. Associated with this transaction, the Company incurred $390,000 of commissions paid to the placement agents.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In May 2004, the Company issued senior debentures in the amount of $12.0 million. The senior debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.2%, which is non-deferrable. At September 30, 2007, the interest rate was 9.70%. The senior debentures are callable by the Company at par after five years from the date of issuance. Associated with this transaction, the Company incurred $360,000 of commissions paid to the placement agents.

The Company contributed $9.9 million of the proceeds to its Insurance Company Subsidiaries and the remaining proceeds were used for general corporate purposes.

The issuance costs associated with these debentures have been capitalized and are included in other assets on the balance sheet. From the time of issuance through June 30, 2007, these issuance costs were being amortized over a seven year period as a component of interest expense. The seven year amortization period represented management s best estimate of the estimated useful life of the bonds related to the senior debentures. Beginning July 1, 2007, the Company reevaluated its best estimate and determined a five year amortization period to be a more accurate representation of the estimated useful life. Therefore, this change in amortization period from seven years to five years has been applied prospectively commencing July 1, 2007.

Junior Subordinated Debentures

In September 2005, Meadowbrook Capital Trust II (the Trust II), an unconsolidated subsidiary trust of the Company, issued $20.0 million of mandatorily redeemable trust preferred securities (TPS) to a trust formed by an institutional investor. Contemporaneously, the Company issued $20.6 million in junior subordinated debentures, which includes the Company s investment in the trust of $620,000. These debentures have financial terms similar to those of the TPS, which includes the deferral of interest payments at any time, or from time-to-time, for a period not exceeding five years, provided there is no event of default. These debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 3.58%. At September 30, 2007, the interest rate was 9.27%. These debentures are callable by the Company at par beginning in October 2010.

The Company received $19.4 million in net proceeds, after the deduction of approximately $600,000 of commissions paid to the placement agents in the transaction.

The Company contributed $10.0 million of the proceeds from the issuance of these debentures to its Insurance Company Subsidiaries and the remaining proceeds were used for general corporate purposes.

In September 2003, Meadowbrook Capital Trust (the Trust), an unconsolidated subsidiary trust of the Company, issued $10.0 million of mandatorily redeemable TPS to a trust formed by an institutional investor. Contemporaneously, the Company issued $10.3 million in junior subordinated debentures, which includes the Company s investment in the trust of $310,000. These debentures have financial terms similar to those of the TPS, which includes the deferral of interest payments at any time, or from time-to-time, for a period not exceeding five years, provided there is no event of default. These debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.05%. At September 30, 2007, the interest rate was 9.41%. These debentures are callable by the Company at par beginning in October 2008.

The Company received $9.7 million in net proceeds, after the deduction of approximately $300,000 of commissions paid to the placement agents in the transaction.

The Company contributed $6.3 million of the proceeds from the issuance of these debentures to its Insurance Company Subsidiaries and the remaining proceeds were used for general corporate purposes.

The junior subordinated debentures are unsecured obligations of the Company and are junior to the right of payment to all senior indebtedness of the Company. The Company has guaranteed that the payments made to both Trusts will be distributed by the Trusts to the holders of the TPS.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company estimates that the fair value of the above mentioned junior subordinated debentures and senior debentures issued approximate the gross proceeds of cash received at the time of issuance.

The issuance costs associated with the junior subordinated debentures have been capitalized and are included in other assets on the balance sheet. From the time of issuance through June 30, 2007, these issuance costs were being amortized over a seven year period as a component of interest expense. The seven year amortization period represented management s best estimate of the estimated useful life of the bonds related to the junior subordinated debentures. Beginning July 1, 2007, the Company reevaluated its best estimate and determined a five year amortization period to be a more accurate representation of the estimated useful life. Therefore, this change in amortization period from seven years to five years has been applied prospectively commencing July 1, 2007.

NOTE 5 Derivative Instruments

In October 2005, the Company entered into two interest rate swap transactions to mitigate its interest rate risk on $5.0 million and $20.0 million of the Company s senior debentures and trust preferred securities, respectively. The Company accrues for these transactions in accordance with SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities, as subsequently amended. These interest rate swap transactions have been designated as cash flow hedges and are deemed highly effective hedges under SFAS No. 133. In accordance with SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income. The interest differential to be paid or received is being accrued and is recognized as an adjustment to interest expense.

The first interest rate swap transaction, which relates to $5.0 million of the Company s $12.0 million issuance of senior debentures, has an effective date of October 6, 2005 and ending date of May 24, 2009. The Company is required to make certain quarterly fixed rate payments calculated on a notional amount of $5.0 million, non-amortizing, based on a fixed annual interest rate of 8.925%. The counterparty is obligated to make quarterly floating rate payments to the Company, referencing the same notional amount, based on the three-month LIBOR, plus 4.20%.

The second interest rate swap transaction, which relates to $20.0 million of the Company s $20.0 million issuance of trust preferred securities, has an effective date of October 6, 2005 and ending date of September 16, 2010. The Company is required to make quarterly fixed rate payments calculated on a notional amount of $20.0 million, non-amortizing, based on a fixed annual interest rate of 8.34%. The counterparty is obligated to make quarterly floating rate payments to the Company, referencing the same notional amount, based on the three-month LIBOR, plus 3.58%.

In relation to the above interest rate swaps, the net interest income received for the nine months ended September 30, 2007 and 2006, was approximately $115,000 and $27,000, respectively. For the three months ended September 30, 2007 and 2006, the net interest income received was approximately $39,000 and $36,000, respectively. The total fair value of the interest rate swaps as of September 30, 2007 and December 31, 2006, was approximately ($71,000) and $200,000, respectively. Accumulated other comprehensive income at September 30, 2007 and December 31, 2006, included the accumulated income on the cash flow hedge, net of taxes, of ($46,000) and $130,000, respectively.

In July 2005, the Company made a $2.5 million loan, at an effective interest rate equal to the three-month LIBOR, plus 5.2%, to an unaffiliated insurance agency. In December 2005, the Company loaned an additional $3.5 million to

the same agency. The original $2.5 million demand note was replaced with a $6.0 million convertible note. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due December 20, 2010. This agency has been a producer for the Company for over ten years. As security for the loan, the borrower granted the Company a security interest in its accounts, cash, general intangibles, and other intangible property. Also, the shareholder then pledged 100% of the common shares of three insurance agencies, the common shares owned by the shareholder in another agency, and has executed a personal guaranty. This note is convertible at

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the option of the Company based upon a pre-determined formula, beginning in 2008. The conversion feature of this note is considered an embedded derivative pursuant to SFAS No. 133, and therefore is accounted for separately from the note. At September 30, 2007, the estimated fair value of the derivative was not material to the financial statements.

NOTE 6 Shareholders Equity

On July 19, 2007, the Company completed a secondary offering of 5,500,000 additional shares of its common stock at a price of $9.65 per share. In addition, the underwriters for the offering exercised their over-allotment option of 937,500 additional shares. Including the underwriting discount associated with the offering and other estimated expenses, the Company received total net proceeds of approximately $58.6 million. These net proceeds are being utilized to support organic growth within its underwriting operations, to fund potential select acquisitions and for other general corporate purposes. Upon receipt of the net proceeds, the Company reduced its outstanding line of credit balance from $22.0 million to zero.

At September 30, 2007, shareholders equity was $290.2 million, or $7.85 per common share, compared to $201.7 million, or $6.93 per common share, at December 31, 2006.

In April 2007, the Company purchased the business of U.S. Specialty Underwriters, Inc. for a purchase price of $23.0 million. This purchase price was comprised of $13.0 million in cash and $10.0 million in the Company s common stock. Total additional shares issued for the $10.0 million portion of the purchase price were 907,935 shares.

On February 8, 2007, the Company s Board of Directors and the Compensation Committee of the Board of Directors approved the distribution of the Company s LTIP award for the 2004-2006 plan years, which included both a cash and stock award. The stock portion of the LTIP award was valued at $2.5 million, which resulted in the issuance of 579,496 shares of the Company s common stock. Of the 579,496 shares issued, 191,570 shares were retired for payment of the participant s associated withholding taxes related to the compensation recognized by the participant. Refer to Note 2 *Stock Options, Long Term Incentive Plan, and Deferred Compensation Plan* for further detail. The retirement of the shares for the associated withholding taxes reduced the Company s paid in capital by $1.8 million.

In October 2005, the Company s Board of Directors authorized management to purchase up to 1,000,000 shares of its common stock in market transactions for a period not to exceed twenty-four months. This plan expired on October 27, 2007. For the nine months ended September 30, 2007 and for the year ended December 31, 2006, the Company did not repurchase any common stock. As of September 30, 2007, the cumulative amount the Company repurchased and retired under the current share repurchase plan was 63,000 shares of common stock for a total cost of approximately $372,000. As of September 30, 2007, the Company has available up to 937,000 shares remaining to be purchased.

At the Company s regularly scheduled board meeting on October 26, 2007, the Company s Board of Directors authorized management to purchase up to 1,000,000 shares, or approximately 3%, of the Company s common stock in market transactions for a period not to exceed twenty-four months.

NOTE 7 Regulatory Matters and Rating Agencies

A significant portion of the Company s consolidated assets represent assets of the Insurance Company Subsidiaries. The State of Michigan Office of Financial and Insurance Services (OFIS), restricts the amount of funds that may be

transferred to the holding company in the form of dividends, loans or advances. These restrictions 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

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