HealthMarkets, Inc.
Form 10-Q
August 10, 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 QUARTERLY PERIOD ENDED JUNE 30, 2007.
OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM _________ TO _________
COMMISSION FILE NO. 001-14953

HealthMarkets, Inc.
(Exact name of registrant as specified in its charter)

Delaware	75-2044750
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
9151 Boulevard 26, North Richland Hills, Texas	76180
(Address of principal executive office)	(Zip Code)

Registrant s telephone number, including area code: (817) 255-5200
Not Applicable

Former name, former address and former fiscal year, if changed since last report.
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.
Large accelerated filer o Accelerated filer o Non-accelerated filer þ
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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date. On July 27, 2007 the registrant had 26,852,260 outstanding shares of Class A-1 Common Stock, $.01 Par Value, and 3,853,346 outstanding shares of Class A-2 Common Stock, $.01 Par Value.

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HEALTHMARKETS, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
HEALTHMARKETS, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS
(DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	June 30, 2007 (Unaudited)	December 31, 2006
ASSETS		
Investments		
Securities available for sale		
Fixed maturities, at fair value (cost: 2007 $1,337,915; 2006 $1,391,275)	$ 1,302,075	$ 1,374,403
Equity securities, at fair value (cost: 2007 $313; 2006 $283)	348	318
Policy loans	14,254	14,625
Short-term and other investments	158,746	412,498
Total Investments	1,475,423	1,801,844
Cash and cash equivalents		32,756
Student loans	100,644	105,846
Restricted cash	9,197	16,238
Investment income due and accrued	20,672	22,633
Due premiums	3,557	3,299
Reinsurance receivables	105,066	155,283
Agents and other receivables	43,321	39,232
Deferred acquisition costs	199,784	197,757
Property and equipment, net	67,795	64,436
Goodwill and other intangible assets	86,015	86,871
Recoverable federal income taxes	5,400	23,929
Other assets	42,443	38,205
	$ 2,159,317	$ 2,588,329
LIABILITIES AND STOCKHOLDERS EQUITY		
Policy liabilities		
Future policy and contract benefits	$ 460,488	$ 453,715
Claims	489,675	517,132
Unearned premiums	105,294	151,758
Other policy liabilities	11,401	12,569
Accounts payable and accrued expenses	52,449	48,363
Cash overdraft	1,263	
Other liabilities	96,178	128,018
Deferred federal income tax payable	72,939	73,575
Debt	481,070	556,070

Student loan credit facility	105,100	118,950
Net liabilities of discontinued operations	3,032	3,794
	1,878,889	2,063,944
Commitments and Contingencies (Note E)		
Stockholders Equity		
Preferred stock, par value $0.01 per share		
Common stock, par value $0.01 per share	308	300
Additional paid-in capital	51,372	12,529
Accumulated other comprehensive loss	(23,277)	(12,552)
Retained earnings	257,036	527,978
Treasury stock, at cost	(5,011)	(3,870)
	280,428	524,385
	$ 2,159,317	$ 2,588,329

NOTE: The balance sheet data as of December 31, 2006 has been derived from the audited financial statements at that date.

See Notes to Consolidated Condensed Financial Statements (Unaudited).

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HEALTHMARKETS, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF INCOME (UNAUDITED)
(DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
REVENUE				
Premiums:				
Health	$ 334,504	$ 448,480	$ 668,266	$ 891,030
Life premiums and other considerations	17,444	16,341	33,825	32,480
	351,948	464,821	702,091	923,510
Investment income	26,271	24,155	52,731	51,313
Other income	27,593	26,201	53,208	51,334
Gains on sales of investments	(3,155)	366	(752)	2,541
	402,657	515,543	807,278	1,028,698
BENEFITS AND EXPENSES				
Benefits, claims, and settlement expenses	196,513	255,797	411,844	528,522
Underwriting, acquisition, and insurance expenses	131,898	155,098	253,896	310,505
Variable non-cash stock-based compensation (benefit) expense	1,546	490	(5)	730
Other expenses	24,677	77,872	46,459	102,411
Interest expense	12,849	12,558	25,845	14,338
	367,483	501,815	738,039	956,506
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	35,174	13,728	69,239	72,192
Federal income taxes	12,207	8,048	23,648	27,666
INCOME FROM CONTINUING OPERATIONS	22,967	5,680	45,591	44,526
DISCONTINUED OPERATIONS				
Income from discontinued operations (net of income tax expense (benefit) of $213 and $(19,725) in the three months ended June 30, 2007 and 2006, respectively, and $250 and $(20,568) in the six months ended June 30, 2007 and 2006, respectively)	396	19,701	463	20,362
NET INCOME	$ 23,363	$ 25,381	$ 46,054	$ 64,888
Earnings per share:				
Basic				
Income from continuing operations	$ 0.76	$ 0.17	$ 1.51	$ 1.13
Income from discontinued operations	0.01	0.58	0.01	0.52

Net income	$	0.77	$	0.75	$	1.52	$	1.65
Diluted								
Income from continuing operations	$	0.74	$	0.16	$	1.47	$	1.11
Income from discontinued operations		0.01		0.57		0.01		0.51
Net income	$	0.75	$	0.73	$	1.48	$	1.62

See Notes to Consolidated Condensed Financial Statements (Unaudited).

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HEALTHMARKETS, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
(DOLLARS IN THOUSANDS)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Net income	$ 23,363	$ 25,381	$ 46,054	$ 64,888
Other comprehensive income (loss):				
Unrealized losses on securities available for sale	(21,256)	(16,040)	(18,320)	(38,143)
Reclassification for investment gains (losses) included in net income	229	(504)	(648)	(492)
Effect on other comprehensive income from investment securities	(21,027)	(16,544)	(18,968)	(38,635)
Unrealized gains on derivatives used in cash flow hedging during the period	3,647	2,523	2,738	2,523
Reclassification adjustment for gains (losses) included in net income	(213)	(20)	(273)	(20)
Effect on other comprehensive income from hedging activities	3,434	2,503	2,465	2,503
Other comprehensive loss before tax	(17,593)	(14,041)	(16,503)	(36,132)
Income tax benefit related to items of other comprehensive loss	(6,160)	(4,914)	(5,778)	(12,647)
Other comprehensive loss net of tax provision benefit	(11,433)	(9,127)	(10,725)	(23,485)
Comprehensive income	$ 11,930	$ 16,254	$ 35,329	$ 41,403

See Notes to Consolidated Condensed Financial Statements (Unaudited).

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HEALTHMARKETS, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS (UNAUDITED)
(DOLLARS IN THOUSANDS)

	Six Months Ended June 30,	
	2007	2006
	(In thousands)	
Operating Activities		
Net income	$ 46,054	$ 64,888
Income from discontinued operations	(463)	(20,362)
Adjustments to reconcile net income to cash provided by operating activities:		
Gains (losses) on sales of investments	752	(2,541)
Change in accrued investment income	(259)	(3,045)
Change in due premiums	(258)	27,047
Change in reinsurance receivables	50,217	662
Change in other receivables	(6,856)	80
Change in current income tax payable	18,529	(2,656)
Change in deferred income tax asset	5,141	(18,483)
Change in deferred acquisition costs	(2,027)	6,481
Depreciation and amortization	12,803	10,820
Change in policy liabilities	(65,131)	(64,952)
Change in other liabilities and accrued expenses	(658)	4,461
Variable non-cash stock-based compensation (benefit) expense	(5)	730
Change in prepaid monitoring fees	(6,250)	
Other items, net	4,064	1,665
Cash Provided by continuing operations	55,653	4,795
Cash (Used in) Provided by discontinued operations	(299)	19,874
Net cash Provided by operating activities	55,354	24,669
Investing Activities		
Decrease in investment assets	301,308	127,401
Decrease in student loans	7,423	4,010
Decrease in restricted cash	7,041	2,232
Additions to property and equipment	(12,940)	(5,955)
Intangible asset acquired		(47,500)
Distribution from investment in Grapevine Finance LLC	468	
Decrease (increase) in agents receivables	2,767	(7,925)
Decrease in other investing activities		2,334
Net cash Used in investing activities	306,067	74,597
Financing Activities		
Increase in investment products	(3,183)	(4,618)
Repayment of student loan credit facility	(13,850)	(5,300)

Debt proceeds (proceeds received for merger)		603,100
Repayment of debt	(75,000)	(1,250)
Exercise of stock options	51	118
Purchase of treasury stock	(21,344)	(1,615,276)
Dividends paid	(316,996)	
Change in cash overdraft	1,263	(1,695)
Capitalized debt issuance costs		(32,539)
Equity costs related to Merger		(31,650)
Contributions from private equity investors		985,000
Proceeds from issuance of common stock, net of expenses	404	1,289
Sale of shares to agent plans	34,354	
Other	124	3,555
Net Cash Used in financing activities	(394,177)	(99,266)
Net change in Cash and cash equivalents	(32,756)	
Cash and cash equivalents at beginning of period	32,756	
Cash and cash equivalents at end of period in continuing operations	$	$

See Notes to Consolidated Condensed Financial Statements (Unaudited).

HEALTHMARKETS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (UNAUDITED)
June 30, 2007
NOTE A BASIS OF PRESENTATION

The accompanying unaudited consolidated condensed financial statements for HealthMarkets, Inc. (the Company or HealthMarkets) and its subsidiaries have been prepared in accordance with United States generally accepted accounting principles (GAAP) for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, such financial statements do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments, except as otherwise described herein, consist of normal recurring accruals. Operating results for the three and six month periods ended June 30, 2007 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2007. For further information, refer to the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

Recently Issued Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued FAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (FAS 159). FAS 159 permits an entity to elect fair value as the initial and subsequent measurement attribute for many financial assets and liabilities. Entities electing the fair value option would be required to recognize changes in fair value in earnings. Entities electing the fair value option are required to distinguish on the face of the statement of financial position, the fair value of assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. FAS 159 is effective for fiscal year 2008. The adjustment to reflect the difference between the fair value and the carrying amount would be accounted for as a cumulative-effect adjustment to retained earnings as of the date of initial adoption. The Company is currently evaluating the impact, if any, of FAS 159 on the Consolidated Condensed Financial Statements.

In September 2006, the FASB issued Statement 157, *Fair Value Measurement* (SFAS 157), which defines fair value as the price that would be received to sell an asset or that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. Statement 157 will be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company believes this statement will not have a material effect upon the financial condition or results of operations of the Company.

In 2005, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*, for implementation in the first quarter of 2007. The SOP requires that deferred acquisition costs be expensed in full when the original contract is substantially changed by election or amendment of an existing contract feature or by replacement with a new contract. The Company implemented the SOP for contract changes beginning in the first quarter of 2007 with no material effects to the financial statements at implementation.

NOTE B DEBT

In connection with the Merger completed on April 5, 2006, HealthMarkets, LLC entered into a credit agreement, providing for a $500.0 million term loan facility and a $75.0 million revolving credit facility (which includes a $35.0 million letter of credit sub-facility). The full amount of the term loan was drawn at closing, and the proceeds thereof were used to fund a portion of the consideration paid in the Merger. At June 30, 2007, the Company had an aggregate of $362.5 million of indebtedness outstanding under the term loan facility, which indebtedness bore interest at the London inter-bank offered rate (LIBOR) plus a borrowing margin (1.00%). The Company has not drawn on the $75.0 million revolving credit facility.

The revolving credit facility will mature on April 5, 2011, and the term loan facility will mature on April 5,

2012. The term loan required nominal quarterly installments (not exceeding 0.25% of the aggregate principal amount at the date of issuance) until the maturity date at which time the remaining principal amount is due. Borrowings under the credit agreement may be subject to certain mandatory prepayments. At HealthMarkets, LLC s election, the interest rates per annum applicable to borrowings under the credit agreement will be based on a fluctuating rate of interest measured by reference to either (a) LIBOR plus a borrowing margin, or (b) a base rate plus a borrowing margin. HealthMarkets, LLC will pay (a) fees on the unused loan commitments of the lenders, (b) letter of credit participation fees for all letters of credit issued, plus fronting fees for the letter of credit issuing bank, and (c) other customary fees in respect of the credit facility. Borrowings and other obligations under the credit agreement are secured by a pledge of HealthMarkets, LLC s interest in substantially all of its subsidiaries, including the capital stock of The MEGA Life and Health Insurance Company (MEGA), Mid-West National Life Insurance Company of Tennessee (Mid-West) and The Chesapeake Life Insurance Company (Chesapeake).

On April 5, 2006, HealthMarkets Capital Trust I and HealthMarkets Capital Trust II (two newly formed Delaware statutory business trusts) (collectively the Trusts) issued $100.0 million of floating rate trust preferred securities (the Trust Securities) and $3.1 million of floating rate common securities. The Trusts invested the proceeds from the sale of the Trust Securities, together with the proceeds from the issuance to HealthMarkets, LLC by the Trusts of the common securities, in $100.0 million principal amount of HealthMarkets, LLC s Floating Rate Junior Subordinated Notes due June 15, 2036 (the Notes), of which $50.0 million principal amount accrue interest at a floating rate equal to three-month LIBOR plus 3.05% and $50.0 million principal amount accrue interest at a fixed rate of 8.367% through but excluding June 15, 2011 and thereafter at a floating rate equal to three-month LIBOR plus 3.05%. Distributions on the Trust Securities will be paid at the same interest rates paid on the Notes.

The Notes, which constitute the sole assets of the Trusts, are subordinate and junior in right of payment to all senior indebtedness (as defined in the Indentures) of HealthMarkets, LLC. The Company has fully and unconditionally guaranteed the payment by the Trusts of distributions and other amounts payable under the Trust Securities. The guarantee is subordinated to the same extent as the Notes.

The Trusts are obligated to redeem the Trust Securities when the Notes are paid at maturity or upon any earlier prepayment of the Notes. Prior to June 15, 2011, the Notes may be redeemed only upon the occurrence of certain tax or investment company events at 105.0% of the principal amount thereof in the first year reducing by 1.25% per year until it reaches 100.0%. On and after June 15, 2011 the Notes are redeemable, in whole or in part, at the option of the Company at 100.0% of the principal amount thereof.

On April 29, 2004, UICI Capital Trust I (a newly formed Delaware statutory business trust) (the 2004 Trust) completed the private placement of $15.0 million aggregate issuance amount of floating rate trust preferred securities with an aggregate liquidation value of $15.0 million (the 2004 Trust Preferred Securities). The 2004 Trust invested the $15.0 million proceeds from the sale of the 2004 Trust Preferred Securities, together with the proceeds from the issuance to the Company by the 2004 Trust of its floating rate common securities in the amount of $470,000 (the Common Securities and, collectively with the 2004 Trust Preferred Securities, the 2004 Trust Securities), in an equivalent face amount of the Company s Floating Rate Junior Subordinated Notes due 2034 (the 2004 Notes). The 2004 Notes will mature on April 29, 2034, which date may be accelerated to a date not earlier than April 29, 2009. The 2004 Notes may be prepaid prior to April 29, 2009, at 107.5% of the principal amount thereof, upon the occurrence of certain events, and thereafter at 100.0% of the principal amount thereof. The 2004 Notes, which constitute the sole assets of the 2004 Trust, are subordinate and junior in right of payment to all senior indebtedness (as defined in the Indenture, dated April 29, 2004, governing the terms of the 2004 Notes) of the Company. The 2004 Notes accrue interest at a floating rate equal to three-month LIBOR plus 3.50%, payable quarterly on February 15, May 15, August 15, and November 15 of each year. The quarterly distributions on the 2004 Trust Securities are paid at the same interest rate paid on the 2004 Notes.

The following table sets forth detail of the Company s debt and interest expense (dollars in thousands):

	Principal Amount at June 30, 2007	Interest rate at June 30, 2007	Interest Expense Three Months Ended June 30, 2007	Interest Expense Six Months Ended June 30, 2007
2006 credit agreement:				
Term loan	$ 362,500	6.35%	$ 6,565	$ 13,244
$75 Million revolver (non-use fee)			40	81
Trust preferred securities:				
UICI Capital Trust I	15,470	8.86%	346	689
HealthMarkets Capital Trust I	51,550	8.41%	1,095	2,179
HealthMarkets Capital Trust II	51,550	8.37%	1,090	2,169
Other:				
Interest on Deferred Tax			1,110	2,153
Student loan credit facility	105,100	5.30%	1,425	2,965
Amortization of financing fees			1,178	2,365
Total	$ 586,170		$ 12,849	$ 25,845

Set forth below is the supplemental calculation of the amortization of financing fees included in interest expense associated with the Company s non-student loan debt (dollars in thousands):

	Remaining capitalized amount	Life (years)	Amortization Expense Three months ended June 30, 2007	Amortization Expense Six months ended June 30, 2007
UICI Capital Trust I	$ 155	5	$ 21	$ 42
Term loan credit facility (1)	13,897	6	740	1,493
HealthMarkets Capital Trust I	2,366	5	130	258
HealthMarkets Capital Trust II	2,370	5	129	256
$75 Million Revolver (Non-Use Fee)	2,371	5	158	316
Total	$ 21,159		$ 1,178	$ 2,365

(1) Amortization of financing fees for the three and six month periods ended June 30, 2007

includes $1.2 million and $2.4 million, respectively, of amortization included in interest expense on the Company s statement of income. An additional $2.9 million incurred in the three months ended June 30, 2007 relates to expense from early extinguishment of debt due to the prepayment of debt in the amount of $75.0 million. This additional amount is included in Gains on Sales of Investments in the Company s statement of income in those periods.

Principal payments required for the Company s non-student loan debt for the remainder of 2007 and each of the next five years and thereafter are as follows (in thousands):

Remainder of 2007	$ 0
2008	0
2009	0
2010	0
2011	0
2012	362,500
2013 and thereafter	118,570
	$ 481,070

Management uses derivative instruments to protect against the risk of changes in prevailing interest rates adversely affecting future cash flows associated with the term loan credit facility discussed above. The derivative instrument used by the Company to protect against such risk is the interest rate swap. The Company accounts for its interest rate

swaps in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*.

As with any financial instrument, derivative instruments have inherent risks, primarily market and credit risk. Market risk associated with changes in interest rates is managed as part of the Company s overall market risk monitoring process by establishing and monitoring limits as to the degree of risk that may be undertaken. Credit risk occurs when a counterparty to a derivative contract in which the Company has an unrealized gain fails to perform according to the terms of the agreement. The Company minimizes its credit risk by entering into transactions with counterparties that maintain high credit ratings.

For a derivative instrument designated as a cash flow hedge, the effective portion of changes in the fair value of the derivative instrument is recorded under the caption Unrealized gains (losses) on securities and hedging activities in the Company s Consolidated Condensed Statement of Comprehensive Income and is recognized in the income statement when the hedged item affects results of operations. If it is determined that (i) an interest rate swap is not highly effective in offsetting changes in the cash flows of a hedged item, (ii) the derivative expires or is sold, terminated or exercised, or (iii) the derivative is undesignated as a hedge instrument because it is unlikely that a forecasted transaction will occur, the Company discontinues hedge accounting prospectively.

If hedge accounting is discontinued, the derivative instrument will continue to be carried at fair value, with changes in the fair value of the derivative instrument recognized in the current period s results of operations. When hedge accounting is discontinued because it is probable that a forecasted transaction will not occur, the accumulated gains and losses included in accumulated other comprehensive income will be recognized immediately in results of operations. When hedge accounting is discontinued because the derivative instrument has not been or will not continue to be highly effective as a hedge, hedge accounting is discontinued and the remaining amount in accumulated other comprehensive income is amortized into earnings over the remaining life of the derivative.

At the effective date of the Merger, an affiliate of The Blackstone Group assigned to the Company three interest rate swap agreements with an aggregate notional amount of $300.0 million. The terms of the swaps are 3, 4 and 5 years beginning on April 11, 2006. The Company presents the fair value of the interest rate swap agreements at the end of the period in either Other assets or Other liabilities, as applicable, on its consolidated condensed balance sheet. At June 30, 2007, the interest rate swaps had an aggregate fair value of approximately $2.5 million, which is reflected under the caption Other Assets. The Company redesignated the hedging relationship in February 2007 to hedge the risk of changes in the Company s cash flow attributable to changes in the LIBOR rate applicable to its variable-rate term loan. The Company assesses, on a quarterly basis, the ineffectiveness of the hedging relationship and any gains or losses related to the ineffectiveness are recorded in Other investment income on its consolidated condensed statement of income. During the three and six months ended June 30, 2007, the Company incurred a gain of $112,000 and $54,000, respectively, related to the ineffectiveness of the interest rate swap. The Company does not expect the ineffectiveness related to its hedging activity to be material to the Company s financial results in the future. There were no components of the derivative instruments that were excluded from the assessment of hedge effectiveness.

During the quarter ended June 30, 2007, pretax income of $264,000 ($172,000 net of tax) was reclassified into interest expense as adjustments to interest payments on variable rate debt. In addition, an amount of $163,000 ($106,000 net of tax) was reclassified into earnings from accumulated other comprehensive income associated with the previous termination of the hedging relationship in the fourth quarter of 2006. At June 30, 2007, accumulated other comprehensive income included a deferred after-tax net loss of $6,000 related to the interest rate swaps.

During the six months ended June 30, 2007, pretax income of $543,000 ($353,000 net of tax) was reclassified into interest expense as adjustments to interest payments on variable rate debt. In addition, an amount of $324,000 ($211,000 net of tax) was reclassified into earnings from accumulated other comprehensive income associated with the previous termination of the hedging relationship in the fourth quarter of 2006. At June 30, 2007, the remaining amount of loss recorded in accumulated other comprehensive income associated with previous terminated hedging relationship was $2.2 million ($1.4 million net of tax). This amount is expected to be reclassified into earnings in conjunction with the interest payments on the variable rate debt through April 2011.

The Company uses regression analysis to assess the hedge effectiveness in achieving the offsetting cash flows attributable to the risk being hedged. In addition, the Company utilizes the hypothetical derivative methodology for the measurement of ineffectiveness. Derivative gains and losses not effective in hedging the expected cash flows will be recognized immediately in earnings.

NOTE C FEDERAL INCOME TAXES

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109 *Accounting for Income Taxes*. The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of the tax benefits from the tax position taken or expected to be taken in a tax return. Adoption of this pronouncement did not effect the Company s financial position and no cumulative effect adjustment was required to the January 1, 2007 balance of

retained earnings.

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As of January 1, 2007, the Company maintained a liability for uncertain tax positions in the amount of $1.1 million which consists solely of accrued interest related to a tax position that involves the uncertain timing of a deduction claimed on a tax return. Accrued interest and applicable penalties, if any, on uncertain tax positions are recorded as a component of income taxes but is not significant for the quarter ended June 30, 2007. The uncertain tax position is currently under examination and, if resolved favorably, may decrease the Company s effective tax rate within the next 12 months. The years that remain subject to federal tax examination are all years after 2002.

NOTE D EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(In thousands, except per share amounts)			
Income available to common shareholders:				
Income from continuing operations	$ 22,967	$ 5,680	$ 45,591	$ 44,526
Income from discontinued operations	396	19,701	463	20,362
Net income for basic and diluted earnings per share	$ 23,363	$ 25,381	$ 46,054	$ 64,888
Weighted average shares outstanding ¾ basic earnings per share	30,353	33,992	30,289	39,309
Effect of dilutive securities:				
Employee stock options and other shares	804	717	817	785
Weighted average shares outstanding ¾ dilutive earnings per share	31,157	34,709	31,106	40,094
Basic earnings per share:				
From continuing operations	$ 0.76	$ 0.17	$ 1.51	$ 1.13
From discontinued operations	0.01	0.58	0.01	0.52
Net income	$ 0.77	$ 0.75	$ 1.52	$ 1.65
Diluted earnings per share:				
From continuing operations	$ 0.74	$ 0.16	$ 1.47	$ 1.11
From discontinued operations	0.01	0.57	0.01	0.51
Net income	$ 0.75	$ 0.73	$ 1.48	$ 1.62

As of June 30, 2007, 26,917,310 shares of Class A-1 common stock were issued, of which 26,852,260 were outstanding and 65,050 shares were held in treasury and 3,952,204 shares of Class A-2 common stock were issued, of which 3,892,678 shares were outstanding and 59,526 shares were held in treasury.

NOTE E COMMITMENTS AND CONTINGENCIES

The Company is a party to the following material legal proceedings:

Academic Management Services Corp. Related Litigation

As previously disclosed, in May and June 2004, HealthMarkets and certain officers and current and former directors of HealthMarkets were named as defendants in four separate class action suits arising out of HealthMarkets

announcement in July 2003 of a shortfall in the type and amount of collateral supporting securitized student loan financing facilities of Academic Management Services Corp., formerly a wholly-owned subsidiary of HealthMarkets until its disposition in November 2003. On October 18, 2004, the four separate cases were consolidated as a single action, in HealthMarkets Securities Litigation, Case No. 3-04-CV-1149-P, pending in the United States District Court for the Northern District of Texas, Dallas Division. On May 27, 2005, plaintiffs on behalf of the purported class of similarly situated individuals who purchased HealthMarkets common stock during the period commencing February 7, 2002 and ending on July 21, 2003, filed a First Amended Consolidated Complaint alleging among other things that HealthMarkets, AMS, the Company s former chief financial officer, the Company s former chief executive officer and AMS former president failed to disclose all material facts relating to the condition of AMS, in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. On July 11, 2005, defendants filed a motion to dismiss the consolidated complaint. The Court denied the motion to dismiss the complaint on September 29, 2006. On May 2, 2007, the parties executed a memorandum of understanding confirming the terms of a settlement of this matter. The Company currently believes that resolution of this matter will not have a material adverse effect on the Company s consolidated financial condition or results of operations.

HealthMarkets has agreed to advance the expenses of the individual defendants incurred in connection with the defense of the case, subject to the defendants undertaking to repay such advances unless it is ultimately determined that they are or would have been entitled to indemnification by HealthMarkets under the terms of the Company s bylaws.

Association Group Litigation

The health insurance products issued by the Company s insurance subsidiaries in the self-employed market are primarily issued to members of various membership associations that make available to their members the health insurance and other insurance products issued by the Company s insurance subsidiaries. The associations provide their membership with a number of benefits and products, including the opportunity to apply for health insurance underwritten by the Company s health insurance subsidiaries. As previously disclosed, the Company and/or its insurance company subsidiaries have been named as defendants in numerous cases in California and in other jurisdictions challenging, among other things, the manner in which the defendants market health insurance products in the self-employed market and the nature of the relationship between the Company s insurance companies and the associations that have made available to their members the insurance companies health insurance products. Plaintiffs in such cases generally seek injunctive relief and monetary damages in an unspecified amount. Reference is made to the discussion of these cases contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2006 under the caption Item 3 Legal Proceedings and in Note P of Notes to the Company s Consolidated Financial Statements included in such report.

The Company currently believes that resolution of these proceedings will not have a material adverse effect on the Company s consolidated financial condition or results of operations.

Other Litigation Matters

The Company and its subsidiaries are parties to various other pending and threatened legal proceedings, claims, demands, disputes and other matters arising in the ordinary course of business, including some asserting significant liabilities arising from claims, demands, disputes and other matters with respect to insurance policies, relationships with agents, relationships with former or current employees, and other matters. From time to time, some such matters, where appropriate, may be the subject of internal investigation by management, the Board of Directors, or a committee of the Board of Directors. The Company currently believes that the liability, if any, resulting from the disposition of such proceedings, claims, demands, disputes or matters would not be material to the Company s financial condition or results of operations.

Regulatory Matters

On March 22, 2005, HealthMarkets received notification that the Market Analysis Working Group of the National Association of Insurance Commissioners had chosen the states of Washington and Alaska to lead a multi-state market conduct examination of HealthMarkets principal insurance subsidiaries. The Company believes that approximately 36 states have elected to participate in the examination, which commenced in May 2005 and is ongoing. The examiners have completed the onsite phases of the examination. An exit interview was held on July 17, 2006, in which representatives of the lead states participated. The Company received a draft of the examination report on July 31, 2007. The Company is in the process of evaluating the draft examination report and will respond to it in a timely manner.

The Company s insurance subsidiaries are subject to various other pending market conduct examinations arising in the ordinary course of business. State insurance regulatory agencies have authority to levy monetary fines and penalties and require remedial action resulting from findings made during the course of such market conduct examinations. The Company currently believes that the liability, if any, resulting from the disposition of the multi-state market conduct examination or other market conduct examinations would not be material to the Company s financial condition or results of operations.

NOTE F SEGMENT INFORMATION

The Company s business segments for financial reporting purposes include (i) the Insurance segment (which includes the businesses of the Company s Self-Employed Agency Division (SEA), the Life Insurance Division

and Other Insurance); (ii) Other Key Factors (which includes investment income not allocated to the Insurance segment, realized gains or losses on sale of investments, interest expense on corporate debt, general expenses relating to corporate operations, merger transaction expenses, variable non-cash stock-based compensation and operations that do not constitute reportable operating segments); and (iii) Disposed Operations (which includes the Company s former Star HRG Division and former Student Insurance Division).

Allocations of investment income and certain general expenses are based on a number of assumptions and estimates, and the business segments reported operating results would change if different methods were applied. Certain assets are not individually identifiable by segment and, accordingly, have been allocated by formulas. Segment revenues include premiums and other policy charges and considerations, net investment income, fees and other income. Management does not allocate income taxes to segments. Transactions between reportable operating segments are accounted for under respective agreements, which provide for such transactions generally at cost.

Revenues from continuing operations, income (loss) from continuing operations before federal income taxes, and assets by operating segment are set forth in the tables below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(In thousands)		(In thousands)	
Revenues from continuing operations:				
Insurance:				
Self-Employed Agency Division	$ 362,380	$ 366,401	$ 722,620	$ 729,770
Life Insurance Division	22,706	21,769	44,260	43,828
Other Insurance	7,882	9,454	15,508	19,321
Total Insurance	392,968	397,624	782,388	792,919
Other Key Factors	10,138	9,926	25,859	24,481
Intersegment Eliminations	(490)	(300)	(978)	(579)
Total revenues excluding disposed operations	402,616	407,250	807,269	816,821
Disposed Operations:				
Student Insurance Division		70,815		135,914
Star HRG	41	37,478	9	75,963
Total Disposed Operations	41	108,293	9	211,877
Total revenues	$ 402,657	$ 515,543	$ 807,278	$ 1,028,698

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(In thousands)		(In thousands)	
Income from continuing operations before federal income taxes:				
Insurance:				
Self-Employed Agency Division	$ 49,500	$ 72,216	$ 84,930	$ 119,239
Life Insurance Division	488	1,775	517	2,156
Other Insurance	1	1,026	1,761	2,747

Total Insurance	49,989	75,017	87,208	124,142
Other Key Factors:				
Investment income on equity, interest expense, realized gains and losses, general corporate expenses and other items	(13,412)	(17,633)	(18,473)	(13,705)
Merger transaction expenses		(47,357)		(48,019)
Variable stock-based compensation benefit (expense)	(1,546)	(490)	5	(730)
Total Other Key Factors	(14,958)	(65,480)	(18,468)	(62,454)
Total operating income excluding disposed operations	35,031	9,537	68,740	61,688
Disposed Operations:				
Student Insurance Division	53	2,544	330	7,209
Star HRG Division	90	1,647	169	3,295
Total Disposed Operations	143	4,191	499	10,504
Total income from continuing operations before federal income taxes	$ 35,174	$ 13,728	$ 69,239	$ 72,192

	June 30, 2007	December 31, 2006
	(In thousands)	
***Assets*:**		
Insurance:		
Self-Employed Agency Division	$ 895,062	$ 930,856
Life Insurance Division	540,275	552,723
Other Insurance	15,654	20,419
Total Insurance	1,450,991	1,503,998
Other Key Factors	625,764	943,360
Total Assets excluding Disposed Operation	2,076,755	2,447,358
Disposed Operations:		
Student Insurance Division	82,562	124,738
Star HRG Division		16,233
Total Disposed Operations	82,562	140,971
Total assets	$ 2,159,317	$ 2,588,329

The Student Insurance Division assets of $82.6 million at June 30, 2007 represent a reinsurance receivable associated with a coinsurance agreement entered into with an insurance affiliate of UnitedHealth Group, Incorporated.

NOTE G AGENT AND EMPLOYEE STOCK PLANS

Agent Stock Accumulation Plans

The Company sponsors a series of stock accumulation plans (the Agent Plans) established for the benefit of the independent insurance agents and independent sales representatives associated with UGA Association Field Services, New United Agency, and Cornerstone America.

The Agent Plans generally combine an agent-contribution feature and a Company-match feature. The agent-contribution feature generally provides that eligible participants are permitted to allocate a portion (subject to prescribed limits) of their commissions or other compensation earned on a monthly basis to purchase shares of HealthMarkets Class A-2 common stock at the fair market value of such shares at the time of purchase. Under the Company-match feature of the Agent Plans, participants are eligible to have posted to their respective Agent Plan accounts book credits in the form of equivalent shares based on the number of shares of HealthMarkets Class A-2 common stock purchased by the participant under the agent-contribution feature of the Agent Plans. The matching credits vest over time (generally in prescribed increments over a ten-year period, commencing the plan year following the plan year during which contributions are first made under the agent-contribution feature), and vested matching credits in a participant s plan account in January of each year are converted from book credits to an equivalent number of shares of HealthMarkets common stock. Matching credits forfeited by participants no longer eligible to participate in the Agent Plans are reallocated each year among eligible participants and credited to eligible participants Agent Plan accounts. Share requirements of the Agent Plans may be met from either unissued or treasury shares.

The Agent Plans do not constitute qualified plans under Section 401(a) of the Internal Revenue Code of 1986 or employee benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA), and the Agent Plans are not subject to the vesting, funding, nondiscrimination and other requirements imposed on such plans by the Internal Revenue Code and ERISA.

For financial reporting purposes, the Company accounts for the Company-match feature of its Agent Plans by recognizing compensation expense over the vesting period in an amount equal to the fair market value of vested shares at the date of their vesting and distribution to the participants. The Company estimates its current liability for unvested matching credits by reference to the number of unvested credits, the prevailing fair market value (as determined by the Company s Board of Directors) of the Company s common stock, and the Company s estimate of the percentage of the vesting period that has elapsed up to the current quarter end. Changes in the liability from one quarter to the next are accounted for as an increase in, or decrease to, compensation expense, as the case may be. Upon vesting, the Company reduces the accrued liability (equal to the market value of the vested shares at date of vesting) with a corresponding increase to equity. Unvested matching credits are considered share equivalents outstanding for purposes of the computation of earnings per share.

The portion of compensation expense associated with the Agent Plans reflected in the results of the SEA Division is based on the prevailing fair value of Class A-2 common stock (as determined by the Board of Directors of the Company since the Merger or, prior to the Merger, by reference to the fair value of the Company s common stock) on or about the time the unvested matching credits are granted to participants. In accordance with the terms of the Agent Plans, the Board of Directors of the Company establishes the fair market value of Class A-2 common stock on a quarterly basis. The remaining portion of the compensation expense associated with the Agent Plans (consisting of variable stock-based compensation expense) is reflected in the results of the Company s Other Key Factors business segment.

Set forth in the table below is the total compensation expense and tax benefit associated with the Company s Agent Plans for the three and six months ended June 30, 2007 and 2006:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
	(In thousands)		**(In thousands)**	
SEA Division stock-based compensation expense (1)	$ 1,476	$ 2,986	$ 6,097	$ 5,491
Other Key Factors variable non-cash stock-based compensation (benefit) expense (2)	1,546	490	(5)	730
Total Agent Plan compensation expense	3,022	3,476	6,092	6,221
Related Tax Benefit	1,058	1,217	2,132	2,177
Net expense included in financial results	$ 1,964	$ 2,259	$ 3,960	$ 4,044

(1) Represents the cost of Class A-2 common stock (determined by reference to the prevailing fair value of Class A-2 common stock as determined by the Board of Directors of the Company or, prior to the Merger, by reference to the market price of HealthMarkets (formerly UICI) common shares) on or about the time that

unvested matching credits are granted to participants in the Agent Plan. This amount is reflected in the caption Underwriting, policy acquisition costs, and insurance expenses on the Company s Consolidated Condensed Statement of Operations.

(2) Represents the total stock-based compensation expense associated with the Agent Plans less the expense incurred by the Company on or about the time that unvested matching credits are granted to participants in the Agent Plan. This amount is reflected in the caption Variable non-cash stock-based compensation expense on the Company s Consolidated Condensed Statement of Operations.

In connection with the extraordinary cash dividend (see Note I), the Company added 317,336 unvested credits to the Agent Plans in order to maintain the value of each agent s account after payment of the dividend.

At December 31, 2006, the Company had recorded 1,373,456 unvested matching credits associated with the Agent Plans, of which 423,145 vested in January 2007. Upon vesting, the Company increased additional paid-in capital by $17.3 million, decreased treasury shares by $3.9 million and decreased other liabilities by $21.2 million. At June 30, 2007, the Company had recorded 1,403,131 unvested matching credits.

Agent Plan transactions are not reflected in the Consolidated Condensed Statement of Cash Flows because issuance of equity securities to settle the Company s liabilities under the Agent Plans are non-cash transactions.

Employee Stock Option Plans

At an Executive Compensation Committee meeting held on March 29, 2007, the Committee approved the granting of 4,000 options to purchase shares of Class A-1 common stock at an exercise price of $50.73 to an individual that did not begin employment until April 9, 2007 which corresponds to the grant date. At an Executive Compensation Committee meeting held on May 3, 2007, the Committee approved the granting of 36,500 options to purchase shares of Class A-1 common stock at an exercise price of $50.73, which represented the fair value of Class A-1 common stock as determined by the Board of Directors on the date of grant of such options.

At the Board of Directors meeting held on May 3, 2007, the Board approved an amendment to the 1987 Stock Option Plan (the 1987 Plan) which provided that in the event of an extraordinary cash dividend, the Company may make such adjustments to options granted under the 1987 Plan as it determines are equitable and/or appropriate. The Board approved an adjustment to options pursuant to which the number of options increased and the exercise price of such options decreased. The value of the options was maintained pre- and post-dividend. To prevent a

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dilution in the rights of participants in the 2006 Management Stock Option Plan (the 2006 Plan), the Board of Directors also approved an adjustment of options granted under the 2006 Plan pursuant to which the exercise price was reduced by $10.51 per share the amount of the extraordinary cash dividend. The Company recognized a pre-tax expense of $1.6 million in the second quarter in connection with the modifications. The remaining modification expense of $1.8 million will be recognized over the remaining life of the options.

Set forth below is a summary of stock option transactions including certain information with respect to the Performance-Based Options for which no performance goals have been established:

	Options Outstanding for Accounting (Excludes Options with no Performance Criteria)		**Performance-Based Options with No Performance Based Goals Established**		**Combined Total**
	Number Of Shares	**Average Option Price per Share ($)**	**Number Of Shares**	**Average Option Price per Share ($)**	**Number Of Shares**
Outstanding options at March 31, 2007	1,089,303	36.43	318,759	39.55	1,408,062
Granted (a)	27,001	40.22	13,499	40.22	40,500
Modification additions (b)	24,862				24,862
Expired					
Cancelled	(29,998)	36.17	(10,002)	36.17	(40,000)
Exercised	(20,188)	7.34			(20,188)
Outstanding options at June 30, 2007	1,090,980	26.92	322,256	29.57	1,413,236
Options exercisable at June 30, 2007	253,995	18.96			253,995

(a) Includes 4,000 options approved by the Executive Compensation Committee on March 29, 2007 for an individual whose employment commenced in April, 2007.

(b) Includes 24,862 shares added in connection with

the amendment of the 1987 Plan options.

NOTE H TRANSACTIONS WITH RELATED PARTIES

On April 5, 2006, the Company completed its Merger and, as a result, affiliates of The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners (the Private Equity Investors) held, as of the effective date of the Merger, approximately 55.3%, 22.7% and 11.3%, respectively, of the Company s outstanding equity securities. At June 30, 2007, affiliates of The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners held approximately 53.6%, 22.0% and 11.0%, respectively, of the Company s outstanding equity securities. Certain members of the Board of Directors of the Company are affiliated with the Private Equity Investors; in particular, Chinh E. Chu and Matthew Kabaker serve as Senior Managing Director and a Principal, respectively, of The Blackstone Group, Adrian M. Jones and Sumit Rajpal serve as a Managing Director and Vice President, respectively, of Goldman, Sachs & Co., and Kamil M. Salame is a partner of DLJ Merchant Banking Partners.

In accordance with the terms of Transaction and Monitoring Fee Agreements with advisory affiliates of each of the Private Equity Investors, the advisory affiliates of each of the Private Equity Investors agreed to provide to the Company ongoing monitoring, advisory and consulting services, for which the Company agreed to pay to affiliates of each of The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners an annual monitoring fee in an amount equal to $7.7 million, $3.5 million and $1.3 million, respectively. The annual monitoring fees are in each case subject to upward adjustment in each year based on the ratio of the Company s consolidated earnings before interest, taxes, depreciation and amortization (EBITDA) in such year to consolidated EBITDA in the prior year, provided that the aggregate monitoring fees paid to all advisors pursuant to the Transaction and Monitoring Fee Agreements in any year shall not exceed the greater of $15.0 million or 3% of consolidated EBITDA in such year. The aggregate annual monitoring fees in the amount of $12.5 million payable with respect to 2007 were paid in full to the advisory affiliates of the Private Equity Investors on January 3, 2007. The Company has expensed $6.3 million through June 30, 2007.

On May 3, 2007, the Company s Board of Directors declared an extraordinary cash dividend in the amount of $10.51 per share for Class
A-1 and Class A-2 common stock to holders of record as of close of business on May 9, 2007, payable on May 14, 2007. In connection with the extraordinary cash dividend, affiliates of each of The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners were paid dividends in the amount of $173.3 million, $71.0 million and $35.5 million, respectively. *See* Note I.

On April 20, 2007, the Company s Board of Directors approved a $10.0 million investment by Mid-West National Life Insurance Company of Tennessee in Goldman Sachs Real Estate Partners, L.P., a commercial real estate fund managed by an affiliate of Goldman Sachs Capital Partners. The Company has committed such investment to be funded over a series of capital calls. On July 18, 2007, the Company funded the first capital call in the amount of $1.5 million.

On April 20, 2007, the Company s Board of Directors approved a $10.0 million investment by The MEGA Life and Health Insurance Company in Blackstone Strategic Alliance Fund L.P., a hedge fund of funds managed by an affiliate of The Blackstone Group. The Company has committed such investment to be funded over a series of capital calls, the first of which is expected during the third quarter of 2007.

NOTE I EXTRAORDINARY CASH DIVIDEND

On May 3, 2007, the Company s Board of Directors declared an extraordinary cash dividend in the amount of $10.51 per share for Class
A-1 and Class A-2 common stock to holders of record as of close of business on May 9, 2007, payable on May 14, 2007. In connection with the extraordinary cash dividend, the Company paid dividends to stockholders in the aggregate amount of $317.0 million.

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ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Introduction

The Company s business segments for financial reporting purposes include (i) the Insurance segment (which includes the businesses of the Company s Self-Employed Agency Division (SEA), the Life Insurance Division and Other Insurance); (ii) Other Key Factors (which includes investment income not allocated to the Insurance segment, realized gains or losses on sale of investments, interest expense on corporate debt, general expenses relating to corporate operations, merger transaction expenses, variable non-cash stock-based compensation and operations that do not constitute reportable operating segments); and (iii) Disposed Operations (which includes the Company s former Star HRG Division and former Student Insurance Division).

Results of Operations

The table below sets forth certain summary information about the Company s operating results for the three and six months ended June 30, 2007 and 2006:

	Three Months Ended June 30,		Percentage Increase (Decrease)	Six Months Ended June 30,		Percentage Increase (Decrease)
	2007	2006		2007	2006	
	(Dollars in thousands)			(Dollars in thousands)		
Revenue:						
Premiums:						
Health	$ 334,504	$ 448,480	(25.4)%	$ 668,266	$ 891,030	(25.0)%
Life premiums and other considerations	17,444	16,341	6.7%	33,825	32,480	4.1%
Total premium	351,948	464,821	(24.3)%	702,091	923,510	(24.0)%
Investment income	26,271	24,155	8.8%	52,731	51,313	2.8%
Other income	27,593	26,201	5.3%	53,208	51,334	3.7%
Gains on sale of investments	(3,155)	366	NM	(752)	2,541	NM
Total revenues	402,657	515,543	(21.9)%	807,278	1,028,698	(21.5)%
Benefits and Expenses:						
Benefits, claims, and settlement expenses	196,513	255,797	(23.2)%	411,844	528,522	(22.1)%
Underwriting, policy acquisition costs, and insurance expenses	131,898	155,098	(15.0)%	253,896	310,505	(18.2)%
Variable stock compensation (benefit) expense	1,546	490	NM	(5)	730	NM
Other expenses	24,677	77,872	(68.3)%	46,459	102,411	(54.6)%
Interest expense	12,849	12,558	2..3%	25,845	14,338	80.3%
Total expenses	367,483	501,815	(26.8)%	738,039	956,506	(22.8)%
Income from continuing operations before income taxes	35,174	13,728	NM	69,239	72,192	(4.1)%
Federal income taxes	12,207	8,048	51.7%	23,648	27,666	(14.5)%

Income from continuing operations	22,967	5,680	NM	45,591	44,526	2.4%
Income from discontinued operations (net of income tax)	396	19,701	(98.0)%	463	20,362	(97.7)%
Net income	$ 23,363	$ 25,381	(8.0)%	$ 46,054	$ 64,888	(29.0)%

NM: not meaningful

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Revenues and income from continuing operations before federal income taxes (operating income) by business segment are summarized in the tables below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(In thousands)		(In thousands)	
Revenues from continuing operations:				
Insurance:				
Self-Employed Agency Division	$ 362,380	$ 366,401	$ 722,620	$ 729,770
Life Insurance Division	22,706	21,769	44,260	43,828
Other Insurance	7,882	9,454	15,508	19,321
Total Insurance	392,968	397,624	782,388	792,919
Other Key Factors	10,138	9,926	25,859	24,481
Intersegment Eliminations	(490)	(300)	(978)	(579)
Total revenues excluding disposed operations	402,616	407,250	807,269	816,821
Disposed Operations:				
Student Insurance Division		70,815		135,914
Star HRG	41	37,478	9	75,963
Total Disposed Operations	41	108,293	9	211,877
Total revenues	$ 402,657	$ 515,543	$ 807,278	$ 1,028,698

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(In thousands)		(In thousands)	
Income from continuing operations before federal income taxes:				
Insurance:				
Self-Employed Agency Division	$ 49,500	$ 72,216	$ 84,930	$ 119,239
Life Insurance Division	488	1,775	517	2,156
Other Insurance	1	1,026	1,761	2,747
Total Insurance	49,989	75,017	87,208	124,142
Other Key Factors:				
Investment income on equity, realized gains and losses, interest expense, general corporate expenses and other	(13,412)	(17,633)	(18,473)	(13,705)
Merger transaction expenses		(47,357)		(48,019)
Variable stock-based compensation benefit(expense)	(1,546)	(490)	5	(730)
Total Other Key Factors	(14,958)	(65,480)	(18,468)	(62,454)
Total operating income excluding disposed operations	35,031	9,537	68,740	61,688

Disposed Operations:				
Student Insurance Division	53	2,544	330	7,209
Star HRG Division	90	1,647	169	3,295
Total Disposed Operations	143	4,191	499	10,504
Total income from continuing operations before federal income taxes	$ 35,174	$ 13,728	$ 69,239	$ 72,192

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HealthMarkets results of operations for the three and six months ended June 30, 2007 were particularly impacted by the following factors:

Self- Employed Agency Division

Set forth below is certain summary financial and operating data for the Company s Self-Employed Agency (SEA) Division for the three and six months ended June 30, 2007 and 2006:

	Self-Employed Agency Division					
	Three Months Ended June 30,		Percentage Increase (Decrease)	Six Months Ended June 30,		Percentage Increase (Decrease)
	2007	2006		2007	2006	
	(Dollars in thousands)					
Revenue:						
Earned premium revenue	$ 327,183	$ 332,888	(1.7)%	$ 653,840	$ 664,653	(1.6)%
Investment income (1)	7,681	8,066	(4.8)%	15,590	15,976	(2.4)%
Other income	27,516	25,447	8.1%	53,190	49,141	8.2%
Total revenues	362,380	366,401	(1.1)%	722,620	729,770	(1.0)%
Expenses:						
Benefit expenses	177,885	165,587	7.4%	376,493	352,070	6.9%
Underwriting and policy acquisition expenses	119,740	113,196	5.8%	231,817	228,056	1.6%
Other expenses	15,255	15,402	(1.0)%	29,380	30,405	(3.4)%
Total expenses	312,880	294,185	6.4%	637,690	610,531	4.4%
Operating income	$ 49,500	$ 72,216	(31.5)%	$ 84,930	$ 119,239	(28.8)%
Other operating data:						
Loss ratio (2)	54.4%	49.7%		57.6%	53.0%	
Expense ratio (3)	36.6%	34.0%		35.5%	34.3%	
Combined ratio	91.0%	83.7%		93.1%	87.3%	
Average number of writing agents in period	2,037	2,232		2,070	2,204	
Submitted annualized volume (4)	$ 185,163	$ 204,601		$ 385,826	$ 418,187	

(1) Allocations of investment income and certain general expenses are based on a number of assumptions and estimates, and

the business division s reported operating results would change if different methods were applied.

(2) Defined as total benefit expenses as a percentage of earned premium revenue.

(3) Defined as total underwriting and policy acquisition expenses as a percentage of earned premium revenue.

(4) Submitted annualized premium volume in any period is the aggregate annualized premium amount associated with health insurance applications submitted by the Company s agents in such period for underwriting by the Company.

The SEA Division reported operating income in the three and six month periods ended June 30, 2007 of $49.5 million and $84.9 million, respectively, compared to operating income of $72.2 million and $119.2 million in the corresponding 2006 period. The decrease in operating income in the three-month period ended June 30, 2007 was primarily due to an increase in the loss ratio (from 49.7% in the 2006 three-month period to 54.4% in the 2007 three-month period) and an increase in underwriting and policy acquisition expenses.

Operating income at the SEA Division as a percentage of earned premium revenue (*i.e.,* operating margin) in the three and six month periods ended June 30, 2007 was 15.1% and 13.0%, compared to operating margin of 21.7% and 17.9% in the corresponding 2006 period. The decrease in operating margin is attributable primarily to the

period-over-period increase in the loss ratio as a result of a product mix shift to new health insurance products in the Company s recently introduced CareOne product suite (which provide a higher proportion of the premium as benefits) and cost containment expenses resulting from the Company s initiatives to control medical costs, the benefits of which have not yet been fully realized. In addition, the Company has incurred additional costs related to certain project initiatives to enhance its administrative systems.

In the second quarter of 2006, the Company determined that sufficient provision for large claims could be made within its normal reserve process, eliminating the need for the separate large claim reserve. This refinement resulted in a reduction in the claim liability of $10.8 million. During the second quarter of 2007, a reduction to the claim

liability (approximately $5.0 million) was attributable to an update of the completion factors used in estimating the claim liability for the Accumulated Covered Expense (ACE) rider, an optional benefit available with certain scheduled/basic health insurance products. This adjustment reflects increasing reliance upon actual historical data for the ACE rider and no longer utilizes large claim data derived from other products, though overall claims experience has been used where the historical ACE data is not sufficient. Previously, the completion factors were calculated partially based upon historical data derived from large claims on other products since there was insufficient data related to the ACE product rider to provide accurate and reliable completion factors.

In the three and six months ended June 30, 2007, total SEA Division submitted annualized premium volume (*i.e*., the aggregate annualized premium amount associated with individual and small group health insurance applications submitted by the Company s agents for underwriting by the Company) decreased to $185.2 million and $385.8 million, respectively, from $204.6 million and $418.2 million, respectively, in the corresponding 2006 periods. The period-over-period decreases in submitted annualized premium volume were attributable primarily to a decrease in the average number of writing agents in the field from 2,232 for the three months ended June 30, 2006 to 2,037 for the three months ended June 30, 2007 and a 3.5% decrease in the weekly applications submitted per writing agent. This was partially offset by a 4.8% increase in the average premium per policy in the second quarter of 2007 compared to the comparable period in 2006.

The Company is in the process of implementing several new initiatives established to increase the average number of writing agents and agent productivity through the use of new commission incentive programs, new products and geographic expansion.

Life Insurance Division

Set forth below is certain summary financial and operating data for the Company s Life Insurance Division for the three and six months ended June 30, 2007 and 2006:

	Life Insurance Division					
	Three Months Ended June 30,		Percentage Increase	Six Months Ended June 30,		Percentage Increase
	2007	2006	(Decrease)	2007	2006	(Decrease)
	(Dollars in thousands)					
Revenue:						
Earned premium revenue	$ 17,259	$ 16,376	5.4%	$ 33,529	$ 32,577	2.9%
Investment income (1)	5,145	5,097	1.0%	10,234	10,182	0.5%
Other income	302	296	1.7%	497	1,069	(53.5)%
Total revenues	22,706	21,769	4.3%	44,260	43,828	1.0%
Expenses:						
Benefit expenses	13,701	10,840	26.4%	27,580	22,722	21.4%
Underwriting and policy acquisition expenses	8,517	9,154	(7.0)%	16,163	18,950	(14.7)%
Total expenses	22,218	19,994	11.1%	43,743	41,672	5.0%
Operating income	$ 488	$ 1,775	(72.5)%	$ 517	$ 2,156	(76.0)%

(1) Allocations of investment income and certain general

expenses are based on a number of assumptions and estimates, and the business division s reported operating results would change if different methods were applied.

The Company s Life Insurance Division reported operating income in the three and six month periods ended June 30, 2007 of $488,000 and $517,000, respectively, compared to operating income of $1.8 million and $2.2 million in the corresponding 2006 periods. The decrease in operating income for the three and six month periods ended June 30, 2007 compared to the corresponding 2006 periods was primarily attributable to an increase in death and workers compensation claims during the first half of 2007 partially offset by a decrease in administrative expenses and a first quarter decrease in the amortization of deferred acquisition costs. The decrease in amortization of deferred acquisition costs in the first quarter 2007 period is associated with the refinement of the calculation due to the availability of additional information from the conversion to new actuarial reserving software. Partially offsetting the decrease in amortization of deferred acquisition costs was an increase in unearned revenue liability which decreased premium revenue. The increase in unearned revenue liability is also associated with the refinement of the calculation associated with additional information from the conversion to the new actuarial software.

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In the three and six months ended June 30, 2007, the Company s Life Insurance Division generated annualized paid premium volume (i.e., the aggregate annualized life premium amount associated with new life insurance policies issued by the Company) in the amount of $4.6 million and $8.9 million, compared to $5.9 million and $11.5 million in the corresponding 2006 period. The second quarter 2007 decrease in annualized premium was primarily due to a decrease in the number of agents.

Other Insurance

Set forth below is certain summary financial and operating data for the Company s Other Insurance division for the three and six months ended June 30, 2007 and 2006:

	Other Insurance Division					
	Three Months Ended June 30,		Percentage Increase (Decrease)	Six Months Ended June 30,		Percentage Increase (Decrease)
	2007	2006		2007	2006	
	(Dollars in thousands)					
Revenue:						
Earned premium revenue	$ 7,465	$ 9,126	(18.2)%	$ 14,713	$ 18,664	(21.2)%
Investment income (1)	387	321	20.6%	747	617	21.1%
Other income	30	7	NM	48	40	20.0%
Total revenues	7,882	9,454	(16.6)%	15,508	19,321	(19.7)%
Expenses:						
Benefit expenses	5,074	5,505	(7.8)%	8,249	10,700	(22.9)%
Underwriting and policy acquisition expenses	2,807	2,923	(4.0)%	5,498	5,874	(6.4)%
Total expenses	7,881	8,428	(6.5)%	13,747	16,574	(17.1)%
Operating income	$ 1	$ 1,026	(99.9)%	$ 1,761	$ 2,747	(35.9)%
Other operating data:						
Loss ratio (2)	68.0%	60.3%		56.1%	57.3%	
Expense ratio (3)	37.6%	32.0%		37.4%	31.5%	
Combined ratio	105.6%	92.3%		93.5%	88.8%	

(1) Allocations of investment income and certain general expenses are based on a number of assumptions and estimates, and the business division s reported

operating results would change if different methods were applied.

(2) The loss ratio represents benefits, claims and settlement expenses related to accident insurance and reinsurance contracts stated as a percentage of earned premiums. The expense ratio represents underwriting, contract acquisition costs and expenses related to accident insurance and reinsurance contracts stated as a percentage of earned premiums.

The Other Insurance division consists of the operations of ZON Re USA LLC (an 82.5%-owned subsidiary), which underwrites, administers and issues accidental death, accidental death and dismemberment (AD&D), accident medical and accident disability insurance products, both on a primary and on a reinsurance basis.

For the three and six months ended June 30, 2007, operating income was $1,000 on revenues of $7.9 million and $1.8 million on revenues of $15.5 million, respectively, compared to $1.0 million in operating income on revenues of $9.5 million and $2.7 million in operating income on revenue of $19.3 million, respectively, for corresponding periods in 2006. The decrease in the revenue is due to lower sales for the current year related to increased competitive pressure, which impacts new and renewal business. The increase in the loss ratio from 60.3% for the three months ended June 30, 2006 to 68.0% for the three months ended June 30, 2007 is mainly due to the two large claims on the reinsured business during the second quarter of 2007. In addition to the higher than expected loss ratio, during the quarter the division incurred increased legal fees and settlement costs due to the settlement of certain litigation.

The minor decrease in the loss ratio from 57.3% for the six months ended June 30, 2006 to 56.1% for the six months ended June 30, 2007 is due to better than anticipated experience on some contracts expiring during the first quarter of 2007.

Other Key Factors

The Company s Other Key Factors segment includes investment income not otherwise allocated to the Insurance segment, realized gains and losses, interest expense on corporate debt, general expenses relating to corporate operations, merger transaction expenses, variable stock compensation, and other unallocated items.

Set forth below is certain summary financial data for the Company s Other Key Factors segment for the three and six months ended June 30, 2007 and 2006:

	Other Key Factors					
	Three Months Ended June 30,		Percentage Increase	Six Months Ended June 30,		Percentage Increase
	2007	2006	(Decrease)	2007	2006	(Decrease)
	(Dollars in thousands)					
Investment income on equity	$ 10,836	$ 7,346	47.5%	$ 21,941	$ 17,182	27.7%
Realized gain (losses) on investments	(3,155)	366	NM	(752)	2,541	NM
Merger transaction expenses		(47,357)	(100.0)%		(48,019)	(100.0)%
Interest expense on non-student loan debt	(11,424)	(10,978)	4.1%	(22,879)	(11,310)	NM
Variable stock-based compensation benefit (expense)	(1,546)	(490)	NM	5	(730)	NM
General corporate expenses and other	(9,669)	(14,367)	(32.7)%	(16,783)	(22,118)	(24.1)%
Operating (expense) income	$ (14,958)	$ (65,480)	(77.2)%	$ (18,468)	$ (62,454)	(70.4)%

The Other Key Factors segment reported an operating loss in the three and six month periods ended June 30, 2007 of $15.0 million and $18.5 million, respectively, compared to operating losses of $65.5 million and $62.5 million, respectively in the corresponding 2006 periods.

The decrease in operating loss in the 2007 periods is primarily due to merger related expenses incurred in 2006 partially offset by additional interest expense in the 2007 period associated with the second quarter 2006 Merger-related indebtedness. The decrease in general corporate expenses and other during 2007 compared to 2006 primarily reflects a decrease in spending with external professional service firms for various company initiatives. During the three months ended June 30, 2007, the Company expensed $2.9 million of capitalized debt issuance costs related to the prepayment of principal in the amount of $75.0 million on its term loan facility. This additional amount is included in Gains on Sales of Investments in the Company s statement of income in those periods. *See* Note B of Notes to Consolidated Condensed Financial Statements (Unaudited).

Liquidity and Capital Resources

Historically, the Company s primary sources of cash on a consolidated basis have been premium revenues from policies issued, investment income, fees and other income, and borrowings under a secured student loan credit facility. The primary uses of cash have been payments for benefits, claims and commissions under those policies, servicing of the Company s debt obligations, operating expenses and the funding of student loans generated under the Company s College First Alternative Loan program. In the six months ended June 30, 2007, net cash provided by operations totaled approximately $55.4 million, compared to $24.7 million in the corresponding period of 2006.

HealthMarkets, Inc., is a holding company, the principal assets of which are its investment in its wholly-owned subsidiary, HealthMarkets, LLC, to which, in connection with the Merger, HealthMarkets, Inc. contributed

substantially all of its assets and liabilities. The holding company s ability to fund its cash requirements is largely dependent upon its ability to access cash, by means of dividends or other means, from HealthMarkets, LLC. HealthMarkets, LLC s principal assets are its investments in its separate operating subsidiaries, including its regulated insurance subsidiaries. The agreements governing certain indebtedness incurred by the Company in connection to the Merger contain restrictive covenants, including certain prescribed financial ratios, limitations on additional indebtedness as a percentage of certain defined equity amounts and restrictions on the disposal of certain subsidiaries, including primarily the Company s regulated insurance subsidiaries.

At June 30, 2007 and December 31, 2006, the aggregate cash and cash equivalents and short-term investments held at both the holding company level and HealthMarkets, LLC was $52.3 million and $311.5 million, respectively. The decrease for the six months ended June 30, 2007 is mainly due to a dividend payment in the amount of $317.0

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million and a $75.0 million principal payment on the Term loan, partially offset by $55.4 million of net cash generated from operations.

Prior approval by insurance regulatory authorities is required for the payment by a domestic insurance company of dividends that exceed certain limitations based on statutory surplus and net income. During 2007 (through August 09, 2007), the Company s domestic insurance subsidiaries declared and paid dividends to HealthMarkets, LLC in the amount of $122.2 million, including an extraordinary dividend in the amount of $100.0 million. The extraordinary dividend resulted in the liquidation of approximately $83.6 million of fixed maturities. The remaining amount of ordinary dividends in calendar year 2007 that could be paid by the Company s domestic insurance subsidiaries to HealthMarkets, LLC is approximately $49.0 million. As it has done in the past, the Company will continue to assess the results of operations of the regulated domestic insurance subsidiaries to determine the prudent dividend capability of the subsidiaries, consistent with HealthMarkets practice of maintaining risk-based capital ratios at each of the Company s domestic insurance subsidiaries significantly in excess of minimum requirements. The agreements governing certain indebtedness incurred by the Company in connection with the Merger contain restrictive covenants, including certain prescribed financial ratios, limitations on additional indebtedness as a percentage of certain defined equity amounts and restrictions on the disposal of certain subsidiaries, including primarily the Company s regulated insurance subsidiaries.

Contractual Obligations and Off Balance Sheet Obligations

The agreements governing certain indebtedness incurred by the Company in connection with the Merger contain restrictive covenants, including certain prescribed financial ratios, limitations on additional indebtedness as a percentage of certain defined equity amounts and restrictions on the disposal of certain subsidiaries, including primarily the Company s regulated insurance subsidiaries. Other contractual obligations or off balance sheet arrangements (which consist solely of commitments to fund student loans generated by its former College Fund Life Division and letters of credit) are described in the Company s Annual Report on Form 10-K for the year ended December 31, 2006 under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations.

Set forth below is a summary of