

KINGSWAY FINANCIAL SERVICES INC
Form 10-Q
August 13, 2012

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

FORM 10-Q
(Mark One)

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

June 30, 2012

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

For the quarterly period ended June 30, 2012

Commission File Number: 001-15204

Kingsway Financial Services Inc.
(Exact name of registrant as specified in its charter)

Ontario, Canada
(State or other jurisdiction of
incorporation or organization)

Not Applicable (I.R.S. Employer
Identification No.)

45 St. Clair Avenue West, Suite 400 Toronto, Ontario M4V 1K9
(Address of principal executive offices and zip code)
1-416-848-1171
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer
(Do not check if a smaller reporting company) Smaller Reporting Company

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

The number of shares outstanding of the registrant's common stock as of August 13, 2012 was 13,148,971.

KINGSWAY FINANCIAL SERVICES INC.

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KINGSWAY FINANCIAL SERVICES INC.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Consolidated Balance Sheets

(in thousands, except per share data)

	June 30, 2012 (unaudited)	December 31, 2011
ASSETS		
Investments:		
Fixed maturities, at fair value (amortized cost of \$101,091 and \$91,344, respectively)	\$ 102,963	\$93,651
Equity investments, at fair value (cost of \$2,689 and \$2,689, respectively)	3,225	2,960
Other investments, at cost which approximates fair value	—	488
Short-term investments, at cost which approximates fair value	335	20,334
Total investments	106,523	117,433
Investment in investees	47,904	48,689
Cash and cash equivalents	63,101	85,486
Accrued investment income	2,652	1,999
Premiums receivable, net of allowance for doubtful accounts of \$3,779 and \$3,653, respectively	27,608	28,732
Service fee receivable	18,752	12,947
Other receivables, net of allowance for doubtful accounts of \$806 and \$806, respectively	5,789	6,322
Reinsurance recoverable	5,685	697
Prepaid reinsurance premiums	3,188	2,024
Deferred policy acquisition costs, net	7,634	8,116
Income taxes recoverable	7,132	8,134
Property and equipment, net of accumulated depreciation of \$28,799 and \$27,736	12,479	13,040
Goodwill	510	510
Intangible assets	39,121	39,121
Other assets	1,831	831
TOTAL ASSETS	\$ 349,909	\$374,081
LIABILITIES AND EQUITY		
LIABILITIES		
Unpaid loss and loss adjustment expenses	\$99,650	\$ 120,258
Unearned premiums	41,906	39,423
Reinsurance payable	4,376	1,913
LROC preferred units	11,778	8,845
Senior unsecured debentures	27,947	28,337
Subordinated debt	20,603	16,432
Deferred income tax liability	2,653	2,653
Notes payable	2,418	2,418
Deferred revenue	13,545	11,128
Accrued expenses and other liabilities	28,437	26,269
TOTAL LIABILITIES	253,313	257,676

EQUITY

Common stock, no par value; unlimited number authorized; 13,148,971 and 13,086,471 issued and outstanding at June 30, 2012 and December 31, 2011, respectively	\$296,621	\$296,489	
Additional paid-in capital	15,504	15,403	
Accumulated deficit	(218,230)	(201,208))
Accumulated other comprehensive income	13,047	12,749	
Shareholders' equity attributable to common shareholders	106,942	123,433	
Noncontrolling interests in consolidated subsidiaries	(10,346)	(7,028))
TOTAL EQUITY	96,596	116,405	
TOTAL LIABILITIES AND EQUITY	\$349,909	\$374,081	

See accompanying notes to unaudited consolidated financial statements.

KINGSWAY FINANCIAL SERVICES INC.

Consolidated Statements of Operations
(in thousands, except per share data)
(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Revenue:				
Net premiums earned	\$30,985	\$42,575	\$60,252	\$88,211
Service fee and commission income	8,138	7,806	17,667	16,778
Net investment income	802	1,152	1,632	2,229
Net realized (losses) gains	(23	)(3	)250	(2
Other-than-temporary impairment loss	(488	)—	(488)—
(Loss) gain on change in fair value of debt	(2,418	)11,237	(6,749	)8,632
Other income	2,744	1,311	3,827	3,222
Total revenues	39,740	64,078	76,391	119,070
Expenses:				
Loss and loss adjustment expenses	23,616	37,014	\$45,391	\$78,591
Commissions and premiums taxes	4,747	6,908	9,166	14,286
General and administrative expenses	17,154	22,810	35,955	44,381
Interest expense	1,916	1,833	3,765	3,736
Amortization of other intangible assets	—	18	—	36
Total expenses	47,433	68,583	94,277	141,030
Loss before gain on buy-back of debt, equity in net income (loss) of investees and income tax expense (benefit)	(7,693	)(4,505	)(17,886	)(21,960
Gain on buy-back of debt	—	553	—	553
Equity in net income (loss) of investees	92	(529	)(2,178	)(529
Loss from continuing operations before income tax expense (benefit)	(7,601	)(4,481	)(20,064	)(21,936
Income tax expense (benefit)	116	267	175	(141
Loss from continuing operations	(7,717	)(4,748	)(20,239	)(21,795
Loss on disposal of discontinued operations, net of taxes	—	—	—	(1,293
Net loss	(7,717	)(4,748	)(20,239	)(23,088
Less: net loss attributable to noncontrolling interests in consolidated subsidiaries	(1,700	)(2,190	)(3,214	)(2,724
Net loss attributable to common shareholders	\$(6,017	)(2,558	)(17,025	)(20,364
Loss per share - continuing operations:				
Basic:	\$(0.59	)(0.36	)(1.54	)(1.67
Diluted:	(0.59	)(0.36	(1.54	(1.67
Loss per share – net loss:				
Basic:	\$(0.59	)(0.36	)(1.54	)(1.77
Diluted:	(0.59	)(0.36	(1.54	(1.77
Weighted average shares outstanding (in '000s):				
Basic:	13,149	13,086	13,117	13,055
Diluted:	13,149	13,086	13,117	13,055

See accompanying notes to unaudited consolidated financial statements.

KINGSWAY FINANCIAL SERVICES INC.

Consolidated Statements of Comprehensive Loss
(in thousands)
(unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Net loss	\$(7,717	) \$(4,748	) \$(20,239	) \$(23,088
Other comprehensive (loss) income, net of taxes ⁽¹⁾ :				
Unrealized gains (losses) on fixed maturities and equity investments:				
Unrealized gains arising during the period	417	1,056	197	1,163
Reclassification adjustment for (gains) losses included in net loss	(509	) 7	(367	) (40
Foreign currency translation adjustments	(1,497	) 2,314	27	4,866
Equity in other comprehensive income (loss) of investees	28	(688	) 339	(688
Loss on cash flow hedge	—	(1,067	) —	(1,267
Other comprehensive (loss) income	(1,561	) 1,622	196	4,034
Comprehensive loss	(9,278	) (3,126	) \$(20,043	) \$(19,054
Less: comprehensive loss attributable to noncontrolling interests in consolidated subsidiaries	(1,722	) (1,991	) (3,318	) (2,471
Comprehensive loss attributable to common shareholders	\$(7,556	) \$(1,135	) (16,725	) (16,583

(1) Net of income tax expense (benefit) of \$0 for the three and six months ended June 30, 2012 and June 30, 2011.

See accompanying notes to unaudited consolidated financial statements

KINGSWAY FINANCIAL SERVICES INC.

Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Six months ended June 30,	
	2012	2011
Cash provided by (used in):		
Operating activities:		
Net loss	\$(20,239	\$(23,088
Adjustments to reconcile net loss to net cash used in operating activities:		
Loss from discontinued operations and disposal of discontinued operations	—	1,293
Equity in net loss of investees	2,178	529
Depreciation and amortization	1,063	1,192
Stock based compensation expense, net of forfeitures	101	(269
Net realized (gains) losses	(250	)2
Loss (gain) on change in fair value of debt	6,749	(8,632
Deferred income taxes	—	584
Other than temporary impairment loss	488	—
Amortization of fixed maturities premiums and discounts	1,574	414
Realized gain on buy-back of debt	—	(553
Changes in operating assets and liabilities:		
Premiums and service fee receivable	(4,681	)8,373
Reinsurance recoverable	(4,988	)8,283
Deferred policy acquisition costs	482	3,564
Income taxes recoverable	1,002	4,825
Funds held in escrow	—	22,259
Unpaid loss and loss adjustment expenses	(20,608	)31,612
Unearned premiums	2,483	(18,428
Reinsurance payable	2,463	(864
Deferred revenue	2,417	(5,317
Other, net	(1,171	)1,964
Net cash used in operating activities	(30,937	)35,481
Investing activities:		
Proceeds from sale and maturities of fixed maturities	51,145	62,934
Purchase of fixed maturities	(42,223	)56,935
Purchase of equity securities	—	(1,120
Net purchases of short-term investments	—	(6
Net purchases of property and equipment and other intangible assets	(502	)469
Net cash provided by investing activities	8,420	4,404
Financing activities:		
Common stock issued	132	350
Proceeds from issuance of notes payable	—	2,418
Redemption of senior unsecured debentures	—	(10,553
Net cash provided by (used in) financing activities	132	(7,785
Net decrease in cash and cash equivalents	(22,385	)38,862
Cash and cash equivalents at beginning of period	85,486	140,567
Cash and cash equivalents at end of period	\$63,101	\$101,705

See accompanying notes to unaudited consolidated financial statements.

KINGSWAY FINANCIAL SERVICES INC.

NOTE 1 BUSINESS

Kingsway Financial Services Inc. (the "Company" or "Kingsway") was incorporated under the Business Corporations Act (Ontario) on September 19, 1989. Kingsway is a holding company and is engaged, through its subsidiaries, in the property and casualty insurance business.

NOTE 2 BASIS OF PRESENTATION

The accompanying unaudited consolidated interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements of the Company. In the opinion of management, all adjustments necessary for a fair presentation have been included and are of a normal recurring nature. Interim results are not necessarily indicative of the results that may be expected for the year.

The accompanying unaudited consolidated interim financial statements and footnotes should be read in conjunction with the audited consolidated financial statements and footnotes included within our Annual Report on Form 10-K ("2011 Annual Report") for the year ended December 31, 2011.

The unaudited consolidated interim financial statements include the accounts of the Company and its subsidiaries. All material intercompany transactions and balances have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect application of policies and the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from these estimates. Estimates and their underlying assumptions are reviewed on an ongoing basis. Changes in estimates are recorded in the accounting period in which they are determined. The critical accounting estimates and assumptions in the accompanying unaudited consolidated interim financial statements include the provision for unpaid loss and loss adjustment expenses, valuation of fixed maturities and equity investments, valuation of deferred tax assets, valuation of other intangible assets and goodwill recoverability, deferred policy acquisition costs, and fair value assumptions for debt obligations.

The fair values of the Company's investments in fixed maturities and equity investments, LROC preferred units, senior unsecured debentures and subordinated debt are estimated using a fair value hierarchy to categorize the inputs it uses in valuation techniques. The fair value disclosure of the Company's investment in investees is based on quoted market prices. Fair values for other investments approximate their unpaid principal balances. The carrying amounts reported in the consolidated balance sheets approximate fair values for cash, short-term investments and certain other assets and other liabilities because of their short-term nature.

The Company's financial results contained herein are reported in U.S. dollars unless otherwise indicated.

NOTE 3 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

There have been no material changes to our significant accounting policies as reported in our 2011 Annual Report, except for the effects of adopting Accounting Standards Update ("ASU") 2010-26, Financial Services-Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts ("ASU 2010-26"). Refer to Note 8, "Deferred Policy Acquisition Costs," for further disclosure.

NOTE 4 RECENTLY ISSUED ACCOUNTING STANDARDS

In October 2010, the Financial Accounting Standards Board ("FASB") issued ASU 2010-26. The amendments in ASU 2010-26 address diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. And, the amendments clarify which costs should be deferred and which costs should be expensed when incurred. The amendments in ASU 2010-26 became effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. We adopted this new accounting standard effective January 1, 2012 on a prospective basis. Refer to Note 8, "Deferred Policy Acquisition Costs," for further discussion regarding the impact of this new standard to the Company.

KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2012

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS ("ASU 2011-04"). Most of the changes in the new standard are clarifications of existing guidance, but it expands the disclosures about fair value measurements. It will require the categorization by level of the fair value hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value is required to be disclosed. In addition, for fair value measurements categorized as Level 3 within the fair value hierarchy, the valuation processes and sensitivity of the fair value measurements to changes in unobservable inputs shall be disclosed. This standard is effective for interim and annual periods beginning after December 15, 2011 and should be applied prospectively. Effective January 1, 2012, the Company adopted ASU 2011-04, and the adoption of the new standard did not have a material impact on the consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income ("ASU 2011-05"). ASU 2011-05 requires companies to present the components of net income and comprehensive income in either one or two consecutive financial statements. Companies are no longer permitted to present the components of other comprehensive income as part of the statement of changes in shareholders' equity. Reclassifications from other comprehensive income must be presented in both the consolidated statement of operations and the consolidated statement of other comprehensive income. This standard became effective for interim and annual periods beginning after December 15, 2011, and should be applied retrospectively. In December 2011, the FASB issued ASU 2011-12, Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05 ("ASU 2011-12"). The amendments in ASU 2011-12 delay the effective date of certain provisions in ASU No. 2011-05 that relate to reclassification items until such time as the FASB has time to re-deliberate the presentation of those items. All other provisions of ASU No. 2011-05 take effect on the date originally noted in that ASU. Effective January 1, 2012, the Company adopted ASU 2011-05 and the adoption of the new standard did not have a material impact on the consolidated financial statements.

In September 2011, the FASB issued ASU 2011-08, Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment ("ASU 2011-08"). The standard became effective for the first interim or annual period beginning on or after December 15, 2011, with early adoption permitted. The standard amends Accounting Standards Codification Topic 350, Intangibles-Goodwill and Other, and gave companies the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Effective January 1, 2012, the Company adopted ASU 2011-08 and the adoption did not have an impact on our financial statements. There have been no triggering events that would suggest possible impairment or that it is more-likely-than-not that the fair values of the reporting unit related to our goodwill are less than their carrying amounts. We will utilize the new guidance during our annual impairment testing in December 2012.

In July 2012, the FASB issued ASU 2012-02, Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment ("ASU 2012-02"). ASU 2012-02 provides entities with an option to first assess qualitative factors to determine whether events or circumstances indicate that it is more likely than not that the indefinite-lived intangible asset is impaired. If an entity concludes that it is more than 50% likely that an indefinite-lived intangible asset is not impaired, no further analysis is required. However, if an entity concludes otherwise, it would be required to determine the fair value of the indefinite-lived intangible asset to measure the amount of actual impairment, if any, as currently required under US GAAP. ASU 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. Except for the option to perform the qualitative assessment, the Company does not anticipate that the adoption of the new standard will have a material impact on the Company.

NOTE 5 DISCONTINUED OPERATIONS AND DISPOSITIONS

(a) Discontinued Operations

American Service Insurance Company ("American Service"), American Country Insurance Company ("American Country"), Southern United Fire Insurance Company ("Southern United"), and Jevco Insurance Company ("Jevco")

were disposed of in 2010 and have been classified as discontinued operations and the results of their operations are reported separately for all periods presented.

KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2012

Summarized financial information for discontinued operations is shown below.

(in thousands)	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Disposals:				
Loss on disposal before income taxes	\$—	\$—	\$—	\$(1,670)
Income tax benefit	—	—	—	(377)
Loss on disposal of discontinued operations, net of taxes	\$—	\$—	\$—	\$(1,293)

American Country, American Service and Southern United:

During 2010, Southern United was merged into American Service.

On December 31, 2010, the previously announced going-public transaction involving the Company's subsidiaries American Country and American Service by way of a reverse takeover of JJR VI Acquisition Corp. ("J6") was completed. Upon completion of the transaction, J6 was renamed Atlas Financial Holdings Inc. ("Atlas"), and American Country and American Service became wholly-owned subsidiaries of Atlas. Total consideration to the Company as a result of the transaction was approximately \$57.0 million, consisting of cash of \$7.9 million, preferred shares of Atlas of \$18.0 million, and common shares of Atlas of \$31.1 million. As part of the transaction, a quota-share agreement was put in place for 90% of up to \$10.0 million of adverse development in excess of \$1.0 million, based on the provision for unpaid loss and loss adjustment expenses recorded by Atlas at September 30, 2010. The maximum obligation to the Company is \$9.0 million.

As a result of the disposal of American Country, American Service and Southern United, the Company recognized an after-tax gain of zero for the three months ended June 30, 2011 (\$0.6 million prior year to date).

Jevco:

On January 25, 2010, the Company entered into a definitive purchase agreement with The Westaim Corporation ("Westaim") to sell all of the issued and outstanding shares of Jevco to Westaim. On March 29, 2010, after receipt of all required regulatory approvals, the sale was completed for a purchase price of C\$263.3 million subject to certain future contingent adjustments. The contingent adjustments included up to a C\$20.0 million decrease in the purchase price relating to specific future adverse development in Jevco's provision for unpaid loss and loss adjustment expenses at the end of 2012. On March 31, 2011, the Company settled the C\$20.0 million contingent adjustments related to the Jevco transactions for C\$17.8 million, recording a pre-tax loss of \$2.3 million. As a result of the disposal of Jevco, the Company realized an after-tax loss of zero for the three months ended June 30, 2011 (\$1.9 million prior year to date).

(b) Dispositions

Hamilton Risk Management Company:

On March 30, 2011, the Company's subsidiary, Kingsway America Inc. ("KAI"), sold all of the issued and outstanding shares of its wholly owned subsidiary Hamilton Risk Management Company ("Hamilton") and its subsidiaries, including Kingsway Amigo Insurance Company ("Amigo"), to HRM Acquisition Corp., a wholly owned subsidiary of Acadia Acquisition Partners, L.P. ("Acadia"), in exchange for a \$10.0 million senior promissory note due March 30, 2014, a \$5.0 million junior promissory note due March 30, 2016, and a Class B partnership interest in Acadia, representing a 40% economic interest. A third-party and members of the Hamilton management team hold Class A partnership interests in Acadia representing a 60% economic interest. KAI acts as the general partner of Acadia. As general partner, KAI has control of the policies and financial affairs of Hamilton; therefore, Kingsway will continue to consolidate the financial statements of Hamilton. During the second quarter of 2011, HRM Acquisition Corp. merged into Hamilton. As a result of this transaction, as of June 30, 2012 and December 31, 2011, Hamilton has notes payable balances of \$2.2 million maturing in March 2014 with the third-party and \$0.2 million maturing in June 2015 with members of the Hamilton management team. The notes bear interest at 2% annually.

KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2012

NOTE 6 INVESTMENTS

The amortized cost, gross unrealized gains (losses), and estimated fair value of the Company's investments at June 30, 2012 and December 31, 2011 are summarized in the tables shown below:

(in thousands)	June 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed maturities:				
U.S. government, government agencies and authorities	\$34,032	\$1,140	\$2	\$35,170
Canadian government	3,735	22	—	3,757
States municipalities and political subdivisions	7,174	174	4	7,344
Mortgage-backed	8,180	267	—	8,447
Asset-backed securities and collateralized mortgage obligations	2,121	14	1	2,134
Corporate	45,849	445	183	46,111
Total fixed maturities	\$101,091	\$2,062	\$190	\$102,963
Equity investments	2,689	565	29	3,225
Short-term investments	335	—	—	335
Total investments	\$104,115	\$2,627	\$219	\$106,523
(in thousands)	December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed maturities:				
U.S. government, government agencies and authorities	\$45,316	\$1,498	\$—	\$46,814
Canadian government	3,788	57	55	3,790
States municipalities and political subdivisions	8,195	269	—	8,464
Mortgage-backed	5,958	222	3	6,177
Asset-backed securities and collateralized mortgage obligations	6,414	40	6	6,448
Corporate	21,673	397	112	21,958
Total fixed maturities	\$91,344	\$2,483	\$176	\$93,651
Equity investments	2,689	287	16	2,960
Other investments	488	—	—	488
Short-term investments	20,334	—	—	20,334
Total investments	\$114,855	\$2,770	\$192	\$117,433

KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2012

The table below summarizes the Company's fixed maturities at June 30, 2012, by contractual maturity periods. Actual results may differ as issuers may have the right to call or prepay obligations, with or without penalties, prior to the contractual maturity of these obligations.

(in thousands)

June 30, 2012

Amortized Cost