HALLMARK FINANCIAL SERVICES INC
Form 10-Q
August 09, 2007

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

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

For the quarterly period ended June 30, 2007

Commission file number 001-11252

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

Nevada (State or other jurisdiction of Incorporation or organization)	87-0447375 (I.R.S. Employer Identification No.)
777 Main Street, Suite 1000, Fort Worth, Texas (Address of principal executive offices)	76102 (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes xNo o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer” and “large accelerated filer” in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value $.18 per share - 20,768,252 shares outstanding as of August 8, 2007.

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

INDEX TO FINANCIAL STATEMENTS

Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Balance Sheets
($ in thousands)

	June 30 2007 (unaudited)	December 31 2006 (audited)
ASSETS		
Investments:		
Debt securities, available-for-sale, at market value	$ 160,547	$ 133,030
Equity securities, available-for-sale, at market value	30,192	4,580
Short-term investments, available-for-sale, at market value	64,086	25,275
Total investments	254,825	162,885
Cash and cash equivalents	41,792	81,474
Restricted cash and cash equivalents	10,042	24,569
Premiums receivable	54,569	44,644
Accounts receivable	12,441	13,223
Prepaid reinsurance premium	1,773	1,629
Reinsurance recoverable	6,505	5,930
Deferred policy acquisition costs	20,214	17,145
Excess of cost over fair value of net assets acquired	31,427	31,427
Intangible assets	24,927	26,074
Prepaid expenses	1,187	1,769
Other assets	10,639	5,184
Total assets	$ 470,341	$ 415,953
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes payable	$ 35,130	$ 35,763
Structured settlements	9,794	24,587
Unpaid losses and loss adjustment expenses	104,388	77,564
Unearned premiums	107,859	91,606
Unearned revenue	3,777	5,734
Reinsurance balances payable	1,271	1,060
Accrued agent profit sharing	1,256	1,784
Accrued ceding commission payable	7,059	3,956
Pension liability	2,895	3,126
Deferred federal income taxes	1,225	2,310
Current federal income tax payable	4,652	2,132
Accounts payable and other accrued expenses	26,768	15,600
Total liabilities	306,074	265,222
Commitments and Contingencies		
Stockholders' equity:		

Common stock, $.18 par value (authorized 33,333,333 shares in 2007 and 2006; issued 20,776,080 shares in 2007 and 2006)		3,740		3,740
Additional paid in capital		118,085		117,932
Retained earnings		45,265		31,480
Accumulated other comprehensive loss		(2,746)		(2,344)
Treasury stock, at cost (7,828 shares in 2007 and 2006)		(77)		(77)
Total stockholders' equity		164,267		150,731
	$	470,341	$	415,953

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

Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Statements of Operations
(Unaudited)
($ in thousands, except per share amounts)

	Three Months Ended June 30		Six Months Ended June 30	
	2007	**2006**	**2007**	**2006**
Gross premiums written	$ 66,577	$ 47,876	$ 131,235	$ 95,611
Ceded premiums written	(4,281)	(2,484)	(8,168)	(4,440)
Net premiums written	62,296	45,392	123,067	91,171
Change in unearned premiums	(6,986)	(11,133)	(16,109)	(28,478)
Net premiums earned	55,310	34,259	106,958	62,693
Investment income, net of expenses	3,047	2,236	6,037	4,593
Realized gain (loss)	828	(1,283)	881	(1,366)
Finance charges	1,185	1,216	2,271	1,903
Commission and fees	8,159	10,016	16,064	22,280
Processing and service fees	203	727	475	1,584
Other income	4	16	8	20
Total revenues	68,736	47,187	132,694	91,707
Losses and loss adjustment expenses	30,712	20,199	62,897	36,889
Other operating expenses	23,723	20,027	46,424	41,053
Interest expense	796	1,662	1,582	3,247
Interest expense from amortization of discount on convertible notes	-	8,508	-	9,625
Amortization of intangible asset	573	573	1,146	1,146
Total expenses	55,804	50,969	112,049	91,960
Income (loss) before tax	12,932	(3,782)	20,645	(253)
Income tax expense (benefit)	4,117	(940)	6,860	163
Net income (loss)	$ 8,815	$ (2,842)	$ 13,785	$ (416)
Common stockholders net income (loss) per share:				
Basic	$ 0.42	$ (0.18)	$ 0.66	$ (0.03)
Diluted	$ 0.42	$ (0.18)	$ 0.66	$ (0.03)

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Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss)
(Unaudited)
($ in thousands)

	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Common Stock				
Balance, beginning of period	$ 3,740	$ 2,609	$ 3,740	$ 2,606
Conversion of note payable to common stock	-	589	-	589
Issuance of common stock upon option exercises	-	-	-	3
Balance, end of period	3,740	3,198	3,740	3,198
Additional Paid-In Capital				
Balance, beginning of period	117,983	69,034	117,932	62,907
Discount on convertible notes, net of tax	-	34	-	6,066
Conversion of note payable to common stock	-	24,562	-	24,562
Equity based compensation	102	33	153	57
Exercise of stock options	-	-	-	71
Balance, end of period	118,085	93,663	118,085	93,663
Retained Earnings				
Balance, beginning of period	36,450	24,715	31,480	22,289
Net income (loss)	8,815	(2,842)	13,785	(416)
Balance, end of period	45,265	21,873	45,265	21,873
Accumulated Other Comprehensive Loss				
Balance, beginning of period	(1,982)	(3,417)	(2,344)	(2,597)
Additional minimum pension liability, net of tax	64	32	64	32
Unrealized losses on securities, net of tax	(828)	(283)	(466)	(1,103)
Balance, end of period	(2,746)	(3,668)	(2,746)	(3,668)
Treasury Stock				
Balance, beginning of period	(77)	(77)	(77)	(17)
Acquisition of treasury shares	-	-	-	(100)
Exercise of stock options	-	-	-	40
Balance, end of period	(77)	(77)	(77)	(77)
Stockholders' Equity	$ 164,267	$ 114,989	$ 164,267	$ 114,989
Net income (loss)	$ 8,815	$ (2,842)	$ 13,785	$ (416)

Additional minimum pension liability, net of tax		64		32		64		32
Unrealized losses on securities, net of tax		(828)		(283)		(466)		(1,103)
Comprehensive Income (Loss)	$	8,051	$	(3,093)	$	13,383	$	(1,487)

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

5

Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Statement of Cash Flows
(Unaudited)
($ in thousands)

	Six Months Ended June 30 2007	Six Months Ended June 30 2006
Cash flows from operating activities:		
Net income (loss)	$ 13,785	$ (416)
Adjustments to reconcile net income (loss) to cash provided by operating activities:		
Depreciation and amortization expense	1,564	1,605
Amortization of beneficial conversion feature	-	9,625
Amortization of discount on structured settlement	207	523
Deferred federal income tax benefit	(916)	(5,671)
Realized (gain) loss on investments	(881)	1,366
Change in prepaid reinsurance premiums	(144)	(818)
Change in premiums receivable	(9,925)	(20,346)
Change in accounts receivable	796	(269)
Change in deferred policy acquisition costs	(3,069)	(3,400)
Change in unpaid losses and loss adjustment expenses	26,824	16,288
Change in unearned premiums	16,253	29,293
Change in unearned revenue	(1,957)	(4,088)
Change in accrued agent profit sharing	(528)	(920)
Change in reinsurance recoverable	(575)	(446)
Change in reinsurance balances payable	211	(252)
Change in current federal income tax payable	2,520	751
Change in accrued ceding commission payable	3,103	8
Excess tax benefits from share-based payments	-	(25)
Change in all other liabilities	2,059	6,331
Change in all other assets	(4,733)	534
Net cash provided by operating activities	44,594	29,673
Cash flows from investing activities:		
Purchases of property and equipment	(269)	(249)
Premium finance notes repaid, net of finance notes originated	(633)	(2,368)
Acquisition of subsidiaries, net of cash acquired	-	(25,964)
Change in restricted cash	14,527	180
Purchases of debt and equity securities	(106,636)	(60,430)
Maturities and redemptions of investment securities	62,506	13,268
Net purchases of short-term investments	(38,771)	(37,776)
Net cash used in investing activities	(69,276)	(113,339)
Cash flows from financing activities:		
Proceeds from exercise of employee stock options	-	40
Payment of structured settlement	(15,000)	-

Proceeds from issuance of convertible debt		-		25,000
Proceeds from note payable to related party		-		12,500
Proceeds from revolving loan on credit facility		-		15,000
Net cash (used in) provided by financing activities		(15,000)		52,540
Decrease in cash and cash equivalents		(39,682)		(31,126)
Cash and cash equivalents at beginning of period		81,474		44,528
Cash and cash equivalents at end of period	$	41,792	$	13,402
Supplemental Cash Flow Information:				
Interest paid	$	1,372	$	2,384
Taxes paid	$	5,256	$	5,082

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

Hallmark Financial Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Unaudited)

1. General

Hallmark Financial Services, Inc. ("Hallmark" and, together with subsidiaries, "we," "us" or "our") is an insurance holding company which, through its subsidiaries, engages in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing commercial insurance in Texas, New Mexico, Idaho, Oregon, Montana, Louisiana, Oklahoma, Arkansas and Washington; marketing, distributing, underwriting and servicing non-standard personal automobile insurance in Texas, New Mexico, Arizona, Oklahoma, Arkansas, Louisiana, Idaho, Oregon, Montana, Missouri and Washington; marketing, distributing, underwriting and servicing general aviation insurance in 47 states; and providing other insurance related services.

We pursue our business activities through subsidiaries whose operations are organized into four operating units which are supported by our three insurance company subsidiaries. Our HGA Operating Unit handles standard lines commercial insurance products and services and is comprised of Hallmark General Agency, Inc. ("Hallmark General Agency") and Effective Claims Management, Inc. Our TGA Operating Unit handles primarily excess and surplus lines commercial insurance products and services and is comprised of Texas General Agency, Inc. ("Texas General Agency"), Pan American Acceptance Corporation ("PAAC") and TGA Special Risk, Inc. ("TGASRI"). Our Aerospace Operating Unit handles general aviation insurance products and services and is comprised of Aerospace Insurance Managers, Inc. ("Aerospace Insurance Managers"), Aerospace Special Risk, Inc. ("ASRI") and Aerospace Claims Management Group, Inc. ("ACMG"). Our Phoenix Operating Unit handles non-standard personal automobile insurance products and services and is comprised solely of American Hallmark General Agency, Inc. (which does business as Phoenix Indemnity Insurance Company).

These four operating units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment presently consists solely of the HGA Operating Unit and the Personal Segment presently consists solely of our Phoenix Operating Unit. The Specialty Commercial Segment includes both our TGA Operating Unit and our Aerospace Operating Unit.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial reporting. These financial statements should be read in conjunction with our audited financial statements for the year ended December 31, 2006 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of June 30, 2007 and 2006 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended June 30, 2007 are not necessarily indicative of the operating results to be expected for the full year.

Reclassification

Certain previously reported amounts have been reclassified in order to conform to current year presentation. Such reclassification had no effect on net income or stockholders' equity. Investment balances that were previously reported in Restricted Cash and Investments on the balance sheet have been reclassified to debt securities, available-for-sale, at market value during the current period. The amount reclassified for December 31, 2006 was $7.2 million.

Redesignation of Segments

Each of our four operating units was reported as a separate segment during the first three quarters of 2006. Commencing in the fourth quarter of 2006, our HGA Operating Unit was designated as the sole component of the Standard Commercial Segment, our TGA Operating Unit and our Aerospace Operating Unit were aggregated in the Specialty Commercial Segment, and our Phoenix Operating Unit was designated as the sole component of the Personal Segment.

Reverse Stock Split

All share and per share amounts have been adjusted to reflect a one-for-six reverse split of all issued and unissued shares of our authorized common stock effected July 31, 2006, and a corresponding increase in the par value of our authorized common stock from $0.03 per share to $0.18 per share.

Use of Estimates in the Preparation of the Financial Statements

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Recently Issued Accounting Standards

In September 2005, the American Institute of Certified Public Accountants issued Statement of Position 05-1 "Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts" ("SOP 05-1"). This statement provides guidance on accounting for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in Statement of Financial Accounting Standards No. 97 "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments," previously issued by the Financial Accounting Standards Board ("FASB"). SOP 05-01 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The adoption of SOP 05-01 had no material impact on our financial condition or results of operations.

In June 2006, FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109" ("FIN 48"), was issued. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with FASB Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, as well as providing guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006 with earlier application permitted as long as the company has not yet issued financial statements, including interim financial statements, in the period of adoption. We adopted the provisions of FIN 48 on January 1, 2007. Since we had no unrecognized tax benefits, we recognized no additional liability or reduction in deferred tax asset as a result of the adoption of FIN 48.

We are no longer subject to U. S. federal, state, local or non-U.S. income tax examinations by tax authorities for years prior to 2003.

In September 2006, FASB issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements” (“SFAS 157”). SFAS 157 establishes a separate framework for determining fair values of assets and liabilities that are required by other authoritative GAAP pronouncements to be measured at fair value. In addition, SFAS 157 incorporates and clarifies the guidance in FASB Concepts Statement 7 regarding the use of present value techniques in measuring fair value. SFAS 157 does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of adopting SFAS 157 on our financial statements.

In February 2007, FASB issued Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Liabilities” (“SFAS 159”). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value with changes in fair value included in current earnings. The election is made on specified election dates, can be made on an instrument-by- instrument basis, and is irrevocable. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of adopting SFAS 159 on our financial statements.

3. Business Combinations

We account for business combinations using the purchase method of accounting. The cost of an acquired entity is allocated to the assets acquired (including identified intangible assets) and liabilities assumed based on their estimated fair values. The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed is an asset referred to as “excess of cost over net assets acquired” or “goodwill.” Indirect and general expenses related to business combinations are expensed as incurred.

4. Supplemental Cash Flow Information

Effective January 1, 2006, we acquired the subsidiaries now comprising our TGA Operating Unit and our Aerospace Operating Unit. In conjunction with the acquisitions, cash and cash equivalents were used in the acquisitions as follows (in thousands):

	TGA Operating Unit	Aerospace Operating Unit
Fair value of tangible assets excluding cash and cash equivalents	$ 52,906	$ 8,391
Fair value of intangible assets acquired	31,585	12,575
Capitalized direct expenses	232	36
Structured settlement	(23,542)	-
Liabilities assumed	(48,522)	(7,697)
Cash and cash equivalents used in acquisitions	$ 12,659	$ 13,305

5. Pledged Investments

We have certain of our debt securities pledged for the benefit of various state insurance departments, reinsurers and the sellers of our TGA Operating Unit. These securities are included with our available-for-sale debt securities as we have the ability to trade these securities. We retain the interest earned on these securities. These securities had a carrying value of $16.2 million at June 30, 2007.

6. Share-Based Payment Arrangements

Our 2005 Long Term Incentive Plan ("2005 LTIP") is a stock compensation plan for key employees and non-employee directors that was approved by the shareholders on May 26, 2005. There are 833,333 shares authorized for issuance under the 2005 LTIP. Our 1994 Key Employee Long Term Incentive Plan (the "1994 Employee Plan") and 1994 Non-Employee Director Stock Option Plan (the "1994 Director Plan") both expired in 2004.

As of June 30, 2007, there were incentive stock options to purchase 657,499 shares of our common stock outstanding and non-qualified stock options to purchase 40,000 shares of our common stock outstanding under the 2005 LTIP, leaving 135,834 shares reserved for future issuance. As of June 30, 2007, there were incentive stock options to purchase 93,001 shares outstanding under the 1994 Employee Plan and non-qualified stock options to purchase 23,334 shares outstanding under the 1994 Director Plan. In addition, as of June 30, 2007, there were outstanding non-qualified stock options to purchase 16,666 shares of our common stock granted to certain non-employee directors outside the 1994 Director Plan in lieu of fees for service on our board of directors in 1999. The exercise price of all such outstanding stock options is equal to the fair market value of our common stock on the date of grant.

Options granted under the 1994 Employee Plan prior to October 31, 2003, vest 40% six months from the date of grant and an additional 20% on each of the first three anniversary dates of the grant and terminate ten years from the date of grant. Incentive stock options granted under the 2005 LTIP and the 1994 Employee Plan after October 31, 2003, vest 10%, 20%, 30% and 40% on the first, second, third and fourth anniversary dates of the grant, respectively, and terminate five to ten years from the date of grant. Non-qualified stock options granted under the 2005 LTIP vest 100% six months after the date of grant and terminate ten years from the date of grant. All non-qualified stock options granted under the 1994 Director Plan vest 40% six months from the date of grant and an additional 10% on each of the first six anniversary dates of the grant and terminate ten years from the date of grant. The options granted to non-employee directors outside the 1994 Director Plan fully vested six months after the date of grant and terminate ten years from the date of grant.

A summary of the status of our stock options as of and changes during the year-to-date ended June 30, 2007 is presented below:

	Number of Shares	Average Exercise Price	Contractual Term (Years)	Intrinsic Value ($000)
Outstanding at January 1, 2007	332,334	$ 7.04		
Granted	500,000	$ 12.52		
Exercised	-	$ -		
Forfeited or expired	(1,834)	$ 5.05		
Outstanding at June 30, 2007	830,500	$ 10.35	8.3	$ 1,674
Exercisable at June 30, 2007	138,751	$ 4.79	3.9	$ 1,017

The following table details the intrinsic value of options exercised, total cost of share-based payments charged against income before income tax benefit and the amount of related income tax benefit recognized in income for the periods indicated (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Intrinsic value of options exercised	$ -	$ -	$ -	$ 103
Cost of share-based payments (non-cash)	$ 102	$ 33	$ 153	$ 57
Income tax benefit of share-based payments recognized in income	$ 36	$ 11	$ 54	$ 20

As of June 30, 2007 there was $2.9 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our plans, of which $0.4 million is expected to be recognized in the remainder of 2007, $0.6 million is expected to be recognized in 2008, $0.8 million is expected to be recognized in each of 2009 and 2010 and $0.3 million is expected to be recognized in 2011.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option pricing model. Expected volatilities are based on historical volatility of our common stock. The risk- free interest rates for periods within the contractual term of the options are based on rates for U.S. Treasury Notes with maturity dates corresponding to the options' expected lives on the dates of grant.

The following table details the weighted average grant date fair value and related assumptions for the periods indicated. There were no options granted in either the first quarter of 2007 or 2006.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Grant date fair value per share	$ 4.04	$ 6.26	$ 4.04	$ 6.26
Expected term (in years)	6.4	5.0		