

Edgar Filing: PENN AMERICA GROUP INC - Form 10-Q

PENN AMERICA GROUP INC  
Form 10-Q  
August 08, 2002

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

For the quarterly period ended June 30, 2002

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-22316

Penn-America Group, Inc.

(Exact name of registrant as specified in its charter)

Pennsylvania 23-2731409  
-----  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

420 South York Road, Hatboro, Pennsylvania 19040  
-----  
(Address of principal executive offices, including zip code)

(215) 443-3600  
-----  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such other 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

At August 2, 2002, 11,584,749 shares of the registrant's common stock, \$.01 par value, were outstanding.

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### PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

#### Consolidated Balance Sheets (In thousands, except per share data)

#### ASSETS

##### Investments:

##### Fixed maturities:

Available for sale, at fair value (amortized cost 2002, \$176,016; 2001, \$130,976) \$

Held to maturity, at amortized cost (fair value 2002, \$3,042; 2001, \$15,317)

Equity securities, at fair value (cost 2002, \$25,376; 2001, \$27,770)

Total investments

Cash

Accrued investment income

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Premiums receivable  
 Reinsurance recoverable  
 Prepaid reinsurance premiums  
 Deferred policy acquisition costs  
 Capital lease, affiliate  
 Deferred income taxes  
 Income tax recoverable  
 Other assets

Total assets

-----  
 \$  
 =====

LIABILITIES AND STOCKHOLDERS' EQUITY

Liabilities:

Unpaid losses and loss adjustment expenses  
 Unearned premiums  
 Accounts payable and accrued expenses  
 Capitalized lease obligation, affiliate  
 Income tax payable  
 Other liabilities

\$

Total liabilities

-----  
 -----

Stockholders' equity:

Preferred stock, \$.01 par value; authorized 2,000,000 shares;  
 None issued  
 Common stock, \$.01 par value; authorized 20,000,000 shares;  
 issued 2002 and 2001, 15,334,185 and 15,228,351 shares, respectively;  
 outstanding 2002 and 2001, 11,584,185 and 11,478,351 shares, respectively  
 Additional paid-in capital  
 Accumulated other comprehensive income  
 Retained earnings  
 Treasury stock, 3,750,000 shares at cost  
 Officers' stock loans  
 Unearned compensation from restricted stock awards

Total stockholders' equity

-----  
 -----

Total liabilities and stockholders' equity

\$  
 =====

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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES  
 Consolidated Statements of Operations  
 (Unaudited)

For the three and six months ended June 30, 2002 and 2001  
 (In thousands, except per share data)

		Three months ended June 30,	S
2002	2001		
-----	-----	-----	-----
2002	2001		200
-----	-----		-----

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Revenues				
Premiums earned	\$	27,234	\$	22,206
Net investment income		2,925		2,815
Net realized investment loss		(1,093)		(334)
Total revenues		29,066		24,687
Losses and expenses				
Losses and loss adjustment expenses		17,364		15,453
Amortization of deferred policy acquisition costs		6,739		6,007
Other underwriting expenses		2,166		1,684
Corporate expenses		233		189
Interest expense		35		40
Total losses and expenses		26,537		23,373
Income before income tax		2,529		1,314
Income tax expense		647		320
Net income	\$	1,882	\$	994
Net income per share				
Basic	\$	0.16	\$	0.09
Diluted	\$	0.16	\$	0.09
Weighted average shares outstanding				
Basic		11,574,913		11,407,215
Diluted		11,791,719		11,514,498
Cash dividends per share	\$	0.03875	\$	0.035

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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

Consolidated Statement of Stockholders' Equity  
(Unaudited)

For the six months ended June 30, 2002  
(In thousands, except per share data)

Common Stock	Additional Paid-In Capital	Accumulated Other Compre- hensive Income	Retained Earnings	Treasury Stock
-----	-----	-----	-----	-----

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Balance at December 31, 2001	\$ 152	\$ 70,735	\$ 1,092	\$ 33,334	\$ (24,161)
Net income	--	--	--	3,668	--
Other comprehensive income:					
net unrealized gain on investments, net of tax and reclassification adjustment	--	--	1,439	--	--
Comprehensive income					
Issuance of common stock	1	783	--	--	--
Unearned compensation from restricted stock awards issued	--	--	--	--	--
Amortization of compensation expense from restricted stock awards issued	--	--	--	--	--
Cash dividends paid (\$0.07708 per share)	--	--	--	(891)	--
Balance at June 30, 2002	\$ 153	\$ 71,518	\$ 2,531	\$ 36,111	\$ (24,161)

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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES  
Consolidated Statements of Cash Flows  
(Unaudited)

For the six months ended June 30, 2002 and 2001  
(In thousands)

	Six months ----- 2002 -----
Cash flows from operating activities:	
Net income	\$ 3,668
Adjustments to reconcile net income to net cash provided (used) by operating activities:	
Amortization and depreciation expense	(185)
Net realized investment loss	1,345
Deferred income tax	(516)
Net increase (decrease) in premiums receivable, prepaid reinsurance premiums and unearned premiums	13,298
Net increase in unpaid losses and loss adjustment expenses and reinsurance recoverable	8,011
Accrued investment income	(513)
Deferred policy acquisition costs	(3,108)
Income tax recoverable/payable	177
Other assets	11
Accounts payable and accrued expenses	1,840
Other liabilities	82
Net cash provided (used) by operating activities	24,110
Cash flows from investing activities:	
Purchases of equity securities	--
Purchases of fixed maturities available for sale	(54,296)
Proceeds from sales of equity securities	1,000
Proceeds from sales and maturities of fixed maturities available for sale	9,451

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Proceeds from maturities and calls of fixed maturities held to maturity	12,130
	-----
Net cash used by investing activities	(31,715)
	-----
Cash flows from financing activities:	
Issuance of common stock	295
Officers' stock loans	--
Principal payments on capital lease obligations, affiliate	(71)
Dividends paid	(891)
	-----
Net cash used by financing activities	(667)
	-----
Decrease in cash	(8,272)
Cash, beginning of period	13,129
	-----
Cash, end of period	\$ 4,857
	=====

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### PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

#### Notes to Unaudited Consolidated Financial Statements

##### Note 1 - Organization and Basis of Presentation

Penn-America Group, Inc. ("PAGI") is an insurance holding company. Approximately 40% of the outstanding common stock of PAGI was owned by Penn Independent Corporation ("Penn Independent") at June 30, 2002. The accompanying financial statements include the accounts of PAGI and its wholly owned subsidiary, Penn-America Insurance Company ("Penn-America") and its wholly owned subsidiary, Penn-Star Insurance Company ("Penn-Star"), (collectively the "Company").

The Company markets and underwrites general liability, commercial property and multi-peril insurance for small businesses located primarily in small towns and suburban and rural areas. The Company can write business in all fifty states and the District of Columbia on both an admitted and non-admitted basis.

The accompanying interim condensed unaudited consolidated financial statements and notes have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal and recurring adjustments) considered necessary for a fair presentation of results for the interim periods have been included. All significant intercompany accounts and transactions have been eliminated in consolidation. It is suggested that these interim condensed unaudited consolidated financial statements and related notes be read in conjunction with the financial statements and related notes in the Company's 2001 Annual Report which was incorporated by reference into the Company's Form 10-K for the year ended December 31, 2001. The Company's results of operations for interim periods are not necessarily indicative of the results to be expected for the entire year.

##### Note 2 - Reinsurance

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Premiums earned are presented net of amounts ceded to reinsurers of \$4.1 million and \$3.0 million for the three months ended June 30, 2002 and 2001, respectively. Losses and loss adjustment expenses are presented net of amounts ceded to reinsurers of \$1.1 million and \$0.7 million for the three months ended June 30, 2002 and 2001, respectively.

Premiums earned are net of amounts ceded to reinsurers of \$7.2 million and \$6.0 million for the six months ended June 30, 2002 and 2001, respectively. Losses and loss adjustment expenses are net of amounts ceded to reinsurers of \$2.8 million and \$3.4 million for the six months ended June 30, 2002 and 2001, respectively.

Note 3 - Comprehensive Income

Accumulated other comprehensive income consists solely of unrealized gains or losses on investment securities net of applicable income tax expense or benefit and reclassification adjustments. Comprehensive income was \$4.3 million for the three months ended June 30, 2002 compared with \$0.8 million for the three months ended June 30, 2001. Comprehensive income was \$5.1 million and \$2.4 million for the six months ended June 30, 2002 and 2001, respectively.

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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements  
(continued)

Note 4 - Income Per Share

Income per share for the three and six months ended June 30, 2002 and 2001 is computed by dividing net income by the basic and diluted weighted average number of common shares outstanding during the respective periods. The following table is a reconciliation of the numerators and denominators of the basic and diluted income per share computations:

(in thousands, except per share data)	Three months ended June 30,	
	2002	2001
Basic per share computation:		
Net income	\$ 1,882	\$ 994
Weighted average common shares (1)	11,574,913	11,407,215
Basic net income per share (1)	\$ 0.16	\$ 0.09
Diluted per share computation:		
Net income	\$ 1,882	\$ 994
Weighted average common shares (1)	11,574,913	11,407,215
Additional shares outstanding after the assumed assumed exercise of stock options by applying the treasury stock method (1)	216,806	107,283

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Total shares (1)a	11,791,719 =====	11,514,498 =====
Diluted net income per share (1)a	\$ 0.16 =====	\$ 0.09 =====

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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements  
(continued)

Note 5 - Retroactive Adjustment for Stock Split

The common stock issued and outstanding and treasury stock at December 31, 2001 have been restated to reflect the three-for-two stock split announced on April 11, 2002 and distributed on May 9, 2002. Accordingly, the balance sheet values for common stock and additional paid-in capital have been adjusted for the effect of the stock split. This adjustment resulted in a \$51,000 increase in common stock and a \$51,000 decrease in additional paid-in capital. The following table illustrates share information on a pre stock split and a post stock split basis as of December 31, 2001:

	Pre Stock Split Basis -----	Post Stock Split Basis -----
Common stock issued	10,152,234	15,228,351
Common stock outstanding	7,652,234	11,478,351
Treasury stock	2,500,000	3,750,000

Note 6- Segment Information

The Company had two reportable segments: non-standard personal automobile and commercial lines. These segments were managed separately because they had different customers, pricing and expense structures. The Company exited the non-standard personal automobile business in 1999 and announced that it would run-off its remaining portfolio of such business. The Company will continue to report on this segment separately until the amounts relating to the non-standard personal automobile business become immaterial to the financial statements presented. The Company does not allocate assets between segments because assets are reviewed in total by management for decision-making purposes.

The accounting policies of the segments are the same as those more fully described in the summary of significant accounting policies in Note 1 of the Company's 2001 Annual Report, which was incorporated by reference into the Company's 2001 Form 10-K. The Company evaluates segment results based on profit or loss from operating activities. Segment profits or losses from operations are pre-tax and do not include unallocated expenses but do include investment income attributable to insurance transactions. Segment profit or loss therefore excludes federal income taxes, unallocated expenses and investment income attributable to equity.



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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements  
(continued)

The following is a summary of the Company's segment revenues, expenses and profit:

(in thousands)

	Three months ended June 30, 2017	
	Commercial	Personal Automobile
Premiums earned	\$ 27,234	\$ --
Net investment income and net realized investment loss from insurance operations	1,002	--
Total segment revenues	28,236	--
Segment losses and loss adjustment expenses	17,364	--
Segment expenses	7,913	--
Total segment expenses	25,277	--
Segment income	\$ 2,959	\$ --
Plus unallocated items:		
Net investment income from equity		
Unallocated expenses		
Income tax expense		
Net income		

(in thousands)

	Three months ended June 30, 2018	
	Commercial	Personal Automobile
Premiums earned	\$ 22,200	\$ 6
Net investment income and net realized investment loss from insurance operations	1,568	71
Total segment revenues	23,768	77
Segment losses and loss adjustment expenses	15,750	(297)
Segment expenses	6,558	5
Total segment expenses	22,308	(292)
Segment income	\$ 1,460	\$ 369
Plus unallocated items:		

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Net investment income from equity  
 Unallocated expenses  
 Income tax expense

Net income

Total segment revenue of \$28,236,000 and \$23,845,000 plus unallocated net investment income from equity of \$830,000 and \$842,000 equals total Company revenues of \$29,066,000 and \$24,687,000 for the three months ended June 30, 2002 and 2001, respectively.

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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements  
 (continued)

The following is a summary of the Company's segment revenues, expenses and profit:

(in thousands)

Six months ended June 30, 2002

	Commercial	Personal Automobile	
Premiums earned	\$ 50,217	\$ --	\$
Net investment income and net realized investment loss from insurance operations	2,439	--	
Total segment revenues	52,656	--	
Segment losses and loss adjustment expenses	32,650	--	
Segment expenses	14,234	--	
Total segment expenses	46,884	--	
Segment income	\$ 5,772	\$ --	\$
Plus unallocated items:			
Net investment income from equity			
Unallocated expenses			
Income tax expense			

Net income

(in thousands)

Six months ended June 30, 2001

	Commercial	Personal Automobile	
Premiums earned	\$ 45,226	\$ 22	\$

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Net investment income and net realized investment loss from insurance operations	3,434	155	
	-----		
Total segment revenues	48,660	177	
	-----		
Segment losses and loss adjustment expenses	33,680	(1,493)	
Segment expenses	13,149	10	
	-----		
Total segment expenses	46,829	(1,483)	
	-----		
Segment income	\$ 1,831	\$ 1,660	\$
	-----		
Plus unallocated items:			
Net investment income from equity			
Unallocated expenses			
Income tax expense			

Net income

Total segment revenue of \$52,656,000 and \$48,837,000 plus unallocated net investment income from equity of \$1,974,000 and \$1,844,000 equals total Company revenues of \$54,630,000 and \$50,681,000 for the six months ended June 30, 2002 and 2001, respectively.

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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements  
(continued)

Note 7- Equity Offering

On June 27, 2002, PAGI filed a registration statement with the Securities and Exchange Commission relating to a proposed offering of 4,000,000 shares of its common stock. Until the registration statement is effective, these securities may not be sold nor may offers to buy be accepted. The intended use of the net proceeds of this offering are to support the Company's operations, including contributing capital to the insurance subsidiaries and capitalizing new insurance subsidiaries to support the growth in business, and for working capital and other general corporate purposes.

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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

Management's Discussion and Analysis of Financial Condition  
and Results of Operations

Results of Operations

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Three Months Ended June 30, 2002 and 2001

Premiums earned were \$27.2 million for the three months ended June 30, 2002 compared to \$22.2 million for the three months ended June 30, 2001. The Company previously announced that it was exiting both commercial automobile and non-standard personal automobile lines of business. Premiums earned for these exited lines of business decreased \$1.5 million, or 99.5%, for the three months ended June 30, 2002 compared to the three months ended June 30, 2001. The Company's core commercial lines premiums earned (excluding exited lines of business) increased \$6.5 million, or 31.3%, attributable to the increase in net written premiums for the three months ended June 30, 2002 as compared to the same period of 2001.

Gross written premiums increased 91.8% for the three months ended June 30, 2002 to \$45.2 million compared to \$23.6 million for the three months ended June 30, 2001. This increase was attributable to rate increases, strong growth in new business and higher average exposures per policy.

Net written premiums increased 85.5% for the three months ended June 30, 2002 to \$38.7 million compared to \$20.9 million for the three months ended June 30, 2001. The increase in net written premiums is consistent with the increase in gross written premiums, but was partially offset by higher reinsurance costs.

Net investment income was \$2.9 million for the three months ended June 30, 2002 compared to \$2.8 million for the same period of last year. While average invested assets increased 13.9% for the second quarter of 2002 due to improved operating cash flows, the average investment yield on fixed-income securities was lower in the second quarter of 2002 than in the second quarter of 2001. Also, interest rates on overnight cash balances were lower during the second quarter of 2002 compared to the second quarter of 2001.

Net realized investment loss was \$1.1 million for the three months ended June 30, 2002 compared to \$0.3 million for the three months ended June 30, 2001. The net realized investment loss for the three months ended June 30, 2002 included an other-than-temporary impairment write-down of \$1.1 million on the Company's equity investment in exchange-traded funds.

Losses and loss adjustment expenses increased 12.4% to \$17.4 million for the three months ended June 30, 2002 from \$15.5 million for the three months ended June 30, 2001. The loss ratio for the three months ended June 30, 2002 was 63.8 compared to 69.6 for the three months ended June 30, 2001. The loss ratio is calculated by dividing losses and loss adjustment expenses by premiums earned. The improvement in the loss ratio is primarily attributable to rate increases implemented in 2001 and 2002 and exiting of the commercial automobile line of business.

Amortization of deferred policy acquisition costs (ADAC) increased 12.2% to \$6.7 million for the three months ended June 30, 2002 from \$6.0 million for the three months ended June 30, 2001 primarily due to the growth in premiums earned. This increase was partially offset by a decline in the ratio of ADAC to premiums earned of 24.7 for the three months ended June 30, 2002 compared to 27.1 for the three months ended June 30, 2001. The improvement in this ratio was attributable to the Company writing a larger portion of its business on a non-admitted basis, which is not subject to premium tax expense and has a lower overall commission rate.

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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

### Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Other underwriting expenses increased 28.6% to \$2.2 million for the three months ended June 30, 2002 from \$1.7 million for the three months ended June 30, 2001. This increase is mainly attributable to increases in salary and benefit expenses associated with the hiring of additional underwriting and marketing personnel.

The overall GAAP combined ratio, which is the sum of the loss and expense ratios, decreased to 96.5 for the three months ended June 30, 2002 from 104.2 for the three months ended June 30, 2001. This improvement was primarily due to the decrease in the loss ratio to 63.8 in 2002 compared to 69.6 in 2001. The expense ratio decreased to 32.7 for the three months ended June 30, 2002 from 34.6 for the three months ended June 30, 2001. The expense ratio is calculated by dividing the sum of ADAC and other underwriting expenses by premiums earned. The GAAP combined ratio is a standard measure of underwriting profitability used throughout the property and casualty insurance industry. A ratio below 100.0 generally indicates profitable underwriting results.

The factors described above resulted in net income for the three months ended June 30, 2002 of \$1.9 million or \$0.16 per share (basic and diluted) compared to net income of \$1.0 million or \$0.09 per share (basic and diluted) for the three months ended June 30, 2001.

#### Six Months Ended June 30, 2002 and 2001

Premiums earned were \$50.2 million for the six months ended June 30, 2002 compared to \$45.2 million for the six months ended June 30, 2001. The Company previously announced that it was exiting both commercial automobile and non-standard personal automobile lines of business. Premiums earned for these exited lines of business decreased \$3.6 million, or 99.6%, for the six months ended June 30, 2002 compared to the six months ended June 30, 2001. The Company's core commercial lines premiums earned (excluding exited lines of business) increased \$8.6 million, or 20.6%, attributable to the increase in net written premiums for the six months ended June 30, 2002 as compared to the same period of 2001.

Gross written premiums increased 58.8% for the six months ended June 30, 2002 to \$75.3 million compared to \$47.4 million for the six months ended June 30, 2001. This increase was attributable to rate increases, strong growth in new business and higher average exposures per policy.

Net written premiums increased 55.2% for the six months ended June 30, 2002 to \$65.1 million compared to \$41.9 million for the six months ended June 30, 2001. The increase in net written premiums is consistent with the increase in gross written premiums, but was partially offset by higher reinsurance costs.

Net investment income was \$5.8 million for the six months ended June 30, 2002 compared to \$5.7 million for the same period of last year. While average invested assets increased 10.7% for the six months ended June 30, 2002 due to improved operating cash flows, the average investment yield on fixed-income securities was lower in 2002 than for the six months ended June 30, 2001. Also, interest rates on overnight cash balances were lower during the six months ended June 30, 2002 compared to the same period of 2001.

Net realized investment loss was \$1.3 million for the six months ended June 30, 2002 compared to \$0.2 million for the six months ended June 30, 2001.

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The current period included an other-than-temporary impairment write-down of \$1.3 million on the Company's equity investments in exchange-traded funds.

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### PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

#### Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Losses and loss adjustment expenses increased 1.4% to \$32.7 million for the six months ended June 30, 2002 from \$32.2 million for the six months ended June 30, 2001. The loss ratio for the six months ended June 30, 2002 was 65.0 compared to 71.1 for the six months ended June 30, 2001. This improvement is attributable to rate increases implemented in 2001 and 2002 and exiting of the commercial automobile line of business.

Amortization of deferred policy acquisition costs (ADAC) increased 4.2% to \$12.8 million for the six months ended June 30, 2002 from \$12.2 million for the six months ended June 30, 2001 primarily due to the growth in premiums earned. This increase was partially offset by a decline in the ratio of ADAC to premiums earned of 25.4 for the six months ended June 30, 2002 compared to 27.0 for the six months ended June 30, 2001. The improvement in this ratio was attributable to the Company writing a larger portion of its business on a non-admitted basis, which is not subject to premium tax expense and has a lower overall commission rate.

Other underwriting expenses increased 18.8% to \$3.8 million for the six months ended June 30, 2002 from \$3.2 million for the six months ended June 30, 2001. This increase is mainly attributable to increases in salary and benefit expenses associated with the hiring of additional underwriting and marketing personnel.

The overall GAAP combined ratio for the Company decreased to 98.0 for the six months ended June 30, 2002, from 105.2 for the six months ended June 30, 2001, primarily due to the decrease in the loss ratio to 65.0 in 2002 compared to 71.1 in 2001. The expense ratio was 33.0 for the six months ended June 30, 2002 and 34.1 for the six months ended June 30, 2001.

The factors described above resulted in net income for the six months ended June 30, 2002 of \$3.7 million or \$0.32 per basic share and \$0.31 per diluted share compared to net income of \$2.0 million or \$0.17 per share (basic and diluted) for the six months ended June 30, 2001.

#### Critical Accounting Estimates

The Company is liable for losses and loss adjustment expenses under the terms of the insurance policies it writes. In many cases, several years may lapse between the occurrence of an insured loss, the reporting of the loss and the payment of that loss. The Company reflects its liability for the ultimate payment of all incurred losses and loss adjustment expenses by establishing loss and loss adjustment expense reserves as balance sheet liabilities for both reported and unreported claims.

When a claim involving a probable loss is reported, the Company establishes a case reserve for the estimated amount of its ultimate loss. The estimate of the amount of the ultimate loss is based upon factors such as:

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- o the type of loss,
- o the jurisdiction of the occurrence,
- o our knowledge of the circumstances surrounding the claim,
- o the severity of injury or damage,
- o the potential for ultimate exposure, and
- o policy provisions relating to the claim.

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### PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

#### Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

The Company determines loss adjustment expenses via a formula method that estimates loss adjustment expenses as a percentage of expected indemnity losses based on historical patterns adjusted to current experience.

In addition to case reserves, the Company establishes reserves on an aggregate basis to provide for incurred but not reported losses and loss adjustment expenses, commonly referred to as "IBNR". To establish reserves for IBNR, the Company must estimate the ultimate liability based primarily on past experience. The Company applies a variety of traditional actuarial techniques to estimate its ultimate liability. The techniques recognize, among other factors:

- o the Company's and the industry's experience,
- o historical trends in reserving patterns and loss payments,
- o the impact of claim inflation,
- o the pending level of unpaid claims,
- o the cost of claim settlements,
- o the line of business mix, and
- o the economic environment in which property and casualty insurance companies operate.

The Company continually reviews these estimates and, based on new developments and information, the Company includes adjustments of the probable ultimate liability in the operating results for the periods in which the adjustments are made. In general, initial reserves are based upon the actuarial and underwriting data utilized to set pricing levels and are reviewed as additional information, including claims experience, becomes available. The establishment of loss and loss adjustment expense reserves makes no provision for the broadening of coverage by legislative action or judicial interpretation or for the extraordinary future emergence of new types of losses not sufficiently represented in our historical experience, or which cannot yet be quantified. The Company regularly analyzes its reserves and reviews pricing and reserving methodologies so that future adjustments to prior year reserves can be minimized. However, given the complexity of this process, reserves will require continual updates and the ultimate liability may be higher or lower than previously indicated. The Company does not discount its loss reserves.

During the first six months of 2002, there were no material adjustments to prior year reserves.

#### Liquidity and Capital Resources

Penn-America Group, Inc. (PAGI) is a holding company, the principal asset of which is the common stock of Penn-America Insurance Company. The principal source of cash for the payment of dividends to PAGI's stockholders and

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PAGI operating expenses is dividends from Penn-America Insurance Company. Penn-America Insurance Company's principal sources of funds are underwriting operations, investment income and proceeds from sales and redemptions of investments. Funds are used by Penn-America Insurance Company and Penn-Star Insurance Company principally to pay claims and operating expenses, to purchase investments and to make dividend payments to PAGI. PAGI's future liquidity is dependant on the ability of Penn-America Insurance Company to pay dividends.

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### PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

#### Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Penn-America Insurance Company and Penn-Star Insurance Company are restricted by statute as to the amount of dividends that they may pay without the prior approval from the Pennsylvania Insurance Department. Penn-America Insurance Company may pay dividends to PAGI without advance regulatory approval only from unassigned surplus and only to the extent that all dividends in the past twelve months do not exceed the greater of 10% of total statutory policyholders' surplus, or statutory net income for the prior year. Using these criteria, the available ordinary dividend payable by Penn-America Insurance Company to PAGI for 2002 is \$6,473,325. No ordinary dividends have been paid to PAGI during the six months ended June 30, 2002. Ordinary dividends paid by Penn-America Insurance Company to PAGI in 2001 were \$1.6 million.

Penn-America Insurance Company provides strong incentives to its general agents to produce profitable business through a contingent profit commission structure that is tied directly to underwriting profitability. Payment of these contingent profit commissions has been through the issuance of PAGI common stock and cash. In 2002, PAGI issued 62,836 shares of its common stock at an average value of \$7.79 per share as part of the payment of the 2001 contingent profit commission due to the general agents of Penn-America Insurance Company.

Penn-America Insurance Company and Penn-Star Insurance Company are required by law to maintain a certain minimum level of policyholders' surplus on a statutory accounting basis. Policyholders' surplus is calculated by subtracting total liabilities from total assets. The National Association of Insurance Commissioners adopted risk-based capital standards designed to identify property and casualty insurers that may be inadequately capitalized based on inherent risks of each insurer's assets and liabilities and its mix of net written premiums. Insurers falling below a calculated threshold may be subject to varying degrees of regulatory action. As of December 31, 2001, the policyholders' surplus of Penn-America Insurance Company and Penn-Star Insurance Company was in excess of the prescribed risk-based capital requirements. Penn-America Insurance Company's policyholders' surplus at December 31, 2001 was \$64,733,251 and its regulatory action level was \$17,124,648. Penn-Star Insurance Company's policyholders' surplus at December 31, 2001 was \$33,389,965 and its regulatory action level was \$5,675,459.

Net cash provided by operating activities was \$24.1 million for the six months ended June 30, 2002 compared to net cash used by operating activities of \$1.4 million for the six months ended June 30, 2001. This improvement is mostly attributable to the increase in net written premiums combined with a decrease in paid losses.



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Net cash used by investing activities was \$31.7 million for the six months ended June 30, 2002, compared to \$0.4 million for the six months ended June 30, 2001. This increase is mostly attributable to the improved operating cash flows noted above that were used to purchase fixed maturities available for sale.

Net cash used by financing activities was \$0.7 million for the six months ended June 30, 2002, compared to \$0.6 million for the six months ended June 30, 2001. This increase is mostly attributable to an increase in dividend payments made in the first six months of 2002 compared to the same period of 2001.

On June 27, 2002, PAGI filed a registration statement with the Securities and Exchange Commission relating to a proposed offering of 4,000,000 shares of its common stock. Until the registration statement is effective, these securities may not be sold nor may offers to buy be accepted. The intended use of the net proceeds of this offering are to support the Company's operations, including contributing capital to the

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### PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

#### Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

insurance subsidiaries and capitalizing new insurance subsidiaries to support the growth in business, and for working capital and other general corporate purposes.

#### Investment Portfolio

The Company seeks to maintain sufficient liquidity from operations, investing and financing activities to meet its anticipated insurance obligations and operating and capital expenditure needs. The Company's investment strategy emphasizes quality, liquidity and diversification, as well as total return. With respect to liquidity, the Company considers liability durations, specifically related to loss reserves, when determining desired investment maturities. In addition, maturities have been staggered to produce cash flows for loss payments and reinvestment opportunities. At June 30, 2002, the Company held a total of \$213.1 million in cash and investments. Of this amount, cash represented \$4.9 million, equity securities represented \$23.0 million, and fixed-income securities represented \$185.2 million.

The Company's cash and investments portfolio mix as of June 30, 2002 was as follows:

Fixed income:	
U.S. Treasury securities and obligations of U.S. government agencies	8%
Corporate securities	34%
Mortgage-backed securities	6%
Other structured securities	22%
Municipal securities	17%
	-----
Total fixed income	87%
Cash and short-term	2%
Preferred stock	8%
Common stock	3%

-----  
 100%  
 =====

The Company's fixed-income portfolio of \$185.2 million was 87% of the total cash and investments as of June 30, 2002. Approximately 90% of these securities were rated "A" or better by Standard & Poor's or Moody's. Equity securities, which consist of preferred stocks and common stocks (comprised exclusively of exchange traded funds), were \$23.0 million or 11% of total cash and investments as of June 30, 2002.

As of June 30, 2002, our investment portfolio contained corporate fixed-income and preferred stock securities with a market value of \$88.2 million. A summary of these securities by industry segment is as follows:

Financial institutions	40%
Technology	13%
Communications	12%
Industrial	9%
Consumer, non-cyclical	9%
Consumer, cyclical	5%
Basic materials	5%
All other	7%
	-----
	100%
	=====

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PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

Management's Discussion and Analysis of Financial Condition  
 and Results of Operations (continued)

As of June 30, 2002, the investment portfolio contained \$61.0 million of mortgage-backed, asset-backed and collateralized mortgage obligations. All of these securities were rated "AA-" or better and 80% were rated "AAA" by Standard & Poor's or Moody's. These securities are publicly traded, and have market values obtained from an independent pricing service. Changes in estimated cash flows due to changes in prepayment assumptions from the original purchase assumptions are revised based on current interest rates and the economic environment. The Company had no derivative financial instruments, real estate or mortgages in the investment portfolio as of June 30, 2002. The quality of the fixed-income portfolio as of June 30, 2002 was as follows:

"AAA"	47%
"AA"	21%
"A"	23%
"BBB"	8%
Below "BBB"	1%
	-----
	100%
	=====

The Company regularly evaluates its investment portfolio to identify other-than-temporary impairments of individual securities. The Company considers

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many factors in determining if an other-than-temporary impairment exists, including the length of time and extent to which the market value of the security has been less than cost, the financial condition and near-term prospects of the issuer of the security and the Company's ability and willingness to hold the security until the market value is expected to recover.

The table below summarizes individual securities held by the Company as of June 30, 2002 with unrealized losses that: (1) were in excess of 15% of the security's June 30, 2002 book value and greater than \$150,000; and (2) have been in an unrealized loss position continuously for at least six months prior to June 30, 2002. The table illustrates the hypothetical effect on future net income per share, utilizing diluted weighted average shares outstanding for the six months ended June 30, 2002, if management subsequently determines that the unrealized losses are other-than-temporary. There would be no effect on stockholders' equity.

Security	Description	June 30, 2002		
-----	-----	Book Value	Market Value	Gross Unrealiz Loss ----
AMEX Technology	Exchange-traded fund	\$ 506,400	\$ 333,802	\$ (172,
Anadarko Petroleum Corporation	Preferred stock	1,942,500	1,611,600	(330,
HSBC USA Inc.	Preferred stock	1,030,000	851,000	(179,

The Company believes that the recent decline in the value of the AMEX Technology exchange-traded-fund was a result of the volatility in the equity markets in the second quarter of 2002 that is attributable in part,

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### PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

#### Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

to the disclosures of recent accounting scandals. Management believes that the prospects for recovery in this sector are good, and therefore, the decline is temporary.

The Anadarko Petroleum Corp. and HSBC USA Inc. preferred stock securities are rated BBB- and A+, respectively, by Standard & Poor's (both investment grade ratings) and have consistently paid dividends since their respective purchase dates by the Company. Management believes that the demand for these high-yielding, tax-advantaged securities will increase as profits in the financial services sector increase, and therefore, the decline is temporary.

Three-for-Two Stock Split

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On April 11, 2002, the Company announced a three-for-two stock split to be effected in the form of a 50% stock dividend payable to stockholders of record as of April 25, 2002. The distribution date was May 9, 2002.

### Quantitative and Qualitative Disclosures About Market Risk

The Company's market risk is the potential economic loss principally arising from adverse changes in the market value of financial instruments. The major components of market risk affecting the Company are interest rate risk and equity price risk.

The Company had fixed-income and preferred stock investments with a market value of \$201.3 million at June 30, 2002 subject to interest rate risk. The Company manages its exposure to interest rate risk through a disciplined asset/liability matching and capital management process. In the management of this risk, the characteristics of duration, credit and variability of cash flows are critical elements. These risks constantly are assessed and balanced within the context of the liability and capital position of the Company.

The Company had common equity investments with a market value of \$6.9 million at June 30, 2002 subject to equity price risk. The Company attempts to mitigate equity price risk to its common stock portfolio by investing exclusively in exchange-traded funds (ETFs). ETFs are securities that represent an interest in a trust that owns and holds a basket of common stocks that replicate a major market index (such as the S&P 500 or the Dow Jones Industrial Average) or a portion of a major market index (such as the Value Component of the S&P). Since these securities represent an interest in the equity capital markets as a whole, or a sub-sector thereof, they are a diversified, index-based exposure to common stocks. As such, the value of these ETFs will be determined by the performance of the equity capital markets in general or of a particular sub-sector and reduces equity price risk to a single issuer of stock.

The Company's market risk at June 30, 2002 has not materially changed from that identified at December 31, 2001.

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### PENN-AMERICA GROUP, INC. AND SUBSIDIARIES

#### PART II. OTHER INFORMATION

- Item 1. Legal Proceedings - None
- Item 2. Changes in Securities and Use of Proceeds - None
- Item 3. Default Upon Senior Securities - None
- Item 4. Submission of Matters to a Vote by Security Holders - None
- Item 5. Other Information

On June 27, 2002, PAGI filed a registration statement with the Securities and Exchange Commission relating to a proposed offering of 4,000,000 shares of its common stock. Until the registration statement is effective, these securities may not be sold nor may offers to buy be accepted. The intended use of the net proceeds of

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this offering are to support the Company's operations, including contributing capital to the insurance subsidiaries and capitalizing new insurance subsidiaries to support the growth in business, and for working capital and other general corporate purposes.

Item 6. Exhibits and Reports on Form 8-K

On May 15, 2002, the Company filed a current report on Form 8-K announcing the availability of the first quarter statements of its insurance subsidiaries, Penn-America Insurance Company and Penn-Star Insurance Company, on the Company's website, in hard copy from the Company, or from the Pennsylvania Insurance Department.

On April 11, 2002, the Company filed a current report on Form 8-K announcing that the Board of Directors of the Company unanimously approved a three-for-two stock split of the common stock of the Company. The three-for-two stock split is in the form of a 50% stock dividend, effective for stockholders of record on April 25, 2002 and was distributed on May 9, 2002.

On April 1, 2002, the Company filed a current report on Form 8-K announcing the availability of the Combined Annual Statement of its insurance subsidiaries, Penn-America Insurance Company and Penn-Star Insurance Company, on the Company's website, in hard copy from the Company, or from the Pennsylvania Insurance Department.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Penn-America Group, Inc.

Date: August 7, 2002  
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By: /s/ Jon S. Saltzman  
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Jon S. Saltzman  
President and  
Chief Executive Officer

By: /s/ Joseph F. Morris  
-----  
Joseph F. Morris  
Senior Vice President,  
Chief Financial Officer  
and Treasurer

