

PENN AMERICA GROUP INC
Form 10-Q
May 07, 2004

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

FORM 10-Q

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

For the quarterly period ended March 31, 2004

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 022316

PENN-AMERICA GROUP, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania
(State or other jurisdiction of
incorporation or organization)

23-2731409
(IRS Employer
Identification No.)

420 S. York Road, Hatboro, PA 19040
(Address of principal executive offices) (Zip code)

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

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 No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

As of May 3, 2004, the registrant had 14,765,741 shares of common stock, \$0.01 par value, outstanding.

Penn-America Group, Inc. and Subsidiaries

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**Penn-America Group, Inc. and Subsidiaries
Consolidated Balance Sheets**

| | | |
|--|-------------|----------|
| | (Unaudited) | December |
| | March 31, | 31, |
| | 2004 | 2003 |
| <i>(In thousands, except share data)</i> | | |

Assets

Investments:

Fixed maturities:

| | | |
|---|------------|------------|
| Available for sale, at fair value (amortized cost 2004, \$310,186; 2003, \$315,509) | \$ 320,569 | \$ 323,230 |
| Held to maturity, at amortized cost (fair value 2004, \$291; 2003, \$293) | 275 | 275 |
| Equity securities, at fair value (cost 2004, \$27,949; 2003, \$10,048) | 27,507 | 10,194 |
| | <hr/> | <hr/> |
| Total investments | 348,351 | 333,699 |
| Cash and cash equivalents | 15,542 | 11,976 |
| Accrued investment income | 3,501 | 3,615 |
| Premiums receivable (net of allowances of \$750 for 2004 and 2003) | 24,627 | 19,382 |
| Reinsurance recoverable | 40,500 | 37,996 |
| Prepaid reinsurance premiums | 13,369 | 13,409 |
| Deferred policy acquisition costs | 18,652 | 17,091 |
| Capital lease, affiliate | 1,470 | 1,492 |
| Deferred income taxes | 4,069 | 3,983 |
| Other assets | 1,192 | 1,231 |
| | <hr/> | <hr/> |
| Total assets | \$ 471,273 | \$ 443,874 |

Liabilities & Stockholders' Equity

Liabilities:

| | | |
|--|------------|------------|
| Unpaid losses and loss adjustment expenses | \$ 190,591 | \$ 174,882 |
| Unearned premiums | 100,196 | 92,205 |
| Accounts payable and accrued expenses | 7,468 | 8,983 |
| Capitalized lease obligation, affiliate | 1,231 | 1,273 |
| Junior subordinated debentures | 30,000 | 30,000 |
| Income tax payable | 2,351 | 633 |
| Other liabilities | 3,358 | 5,088 |
| | <hr/> | <hr/> |
| Total liabilities | 335,195 | 313,064 |

Commitments and Contingencies (Note 7)

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 and outstanding 2004 and 2003, 14,765,052 and 14,743,698 shares, respectively | 148 | 147 |
| Additional paid-in capital | 72,708 | 72,416 |
| Accumulated other comprehensive income | 6,213 | 5,027 |
| Retained earnings | 57,777 | 54,005 |
| Officers' stock loans | (569) | (569) |
| Unearned compensation from restricted stock awards | (199) | (216) |
| | <hr/> | <hr/> |
| Total stockholders' equity | 136,078 | 130,810 |

| | | | | |
|--|----|---------|----|---------|
| Total liabilities and stockholders' equity | \$ | 471,273 | \$ | 443,874 |
|--|----|---------|----|---------|

See accompanying Notes to Consolidated Financial Statements.

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Penn-America Group, Inc. and Subsidiaries
Consolidated Statements of Operations
(Unaudited)

| <i>(In thousands, except share data)</i> | Three months ended March 31, | |
|---|------------------------------|-----------------|
| | 2004 | 2003 |
| Revenues | | |
| Premiums earned | \$ 47,455 | \$ 34,365 |
| Net investment income | 3,487 | 3,213 |
| Net realized investment gain | 556 | 714 |
| | | |
| Total revenues | 51,498 | 38,292 |
| | | |
| Losses and expenses | | |
| Losses and loss adjustment expenses | 30,250 | 22,012 |
| Amortization of deferred policy acquisition costs | 11,682 | 8,617 |
| Other underwriting expenses | 2,074 | 2,046 |
| Corporate expenses | 261 | 185 |
| Interest expense | 505 | 304 |
| | | |
| Total losses and expenses | 44,772 | 33,164 |
| | | |
| Income before income tax | 6,726 | 5,128 |
| Income tax expense | 2,068 | 1,554 |
| | | |
| Net income | \$ 4,658 | \$ 3,574 |
| | | |
| Net income per share | | |
| Basic | \$ 0.32 | \$ 0.24 |
| Diluted | \$ 0.31 | \$ 0.24 |
| | | |
| Weighted average shares outstanding | | |
| Basic | 14,753,594 | 14,591,096 |
| Diluted | 14,994,449 | 14,798,913 |
| | | |
| Cash dividend per share | \$ 0.06 | \$ 0.04375 |

See accompanying Notes to Consolidated Financial Statements.

Penn-America Group, Inc. and Subsidiaries
Consolidated Statement of Stockholders' Equity
Three Months Ended March 31, 2004
(Unaudited)

| <i>(In thousands, except share data)</i> | Common Stock | Additional Paid-in Capital | Accumulated Other Comprehensive Income | Retained Earnings | Officers Stock Loans | Unearned Compensation From Restricted Stock Awards | Total Stockholders Equity |
|--|-----------------|----------------------------------|---|----------------------|----------------------------|---|---------------------------------|
| Balance at December 31, 2003 | \$ 147 | \$ 72,416 | \$ 5,027 | \$ 54,005 | \$ (569) | \$ (216) | \$ 130,810 |
| Net income | --- | --- | --- | 4,658 | --- | --- | 4,658 |
| Other comprehensive gain: | | | | | | | |
| Unrealized gain on investments, net of tax and reclassification adjustment | --- | --- | 1,348 | --- | --- | --- | 1,348 |
| Unrealized loss on cash flow hedging instrument, net of tax | --- | --- | (162) | --- | --- | --- | (162) |
| Comprehensive income | | | | | | | <u>5,844</u> |
| Issuance of common stock | 1 | 273 | --- | --- | --- | --- | 274 |
| Compensation expense on stock options | --- | 19 | --- | --- | --- | --- | 19 |
| Amortization of unearned compensation from restricted stock awards issued | --- | --- | --- | --- | --- | 17 | 17 |
| Cash dividend paid (\$0.06 per share) | --- | --- | --- | (886) | --- | --- | (886) |
| Balance at March 31, 2004 | <u>\$ 148</u> | <u>\$ 72,708</u> | <u>\$ 6,213</u> | <u>\$ 57,777</u> | <u>\$ (569)</u> | <u>\$ (199)</u> | <u>\$ 136,078</u> |

See accompanying Notes to Consolidated Financial Statements.

Penn-America Group, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)

Three months ended March 31,

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| <i>(In thousands)</i> | 2004 | 2003 |
|--|------------------|-----------------|
| Cash flows from operating activities: | | |
| Net income | \$ 4,658 | \$ 3,574 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization/accretion and depreciation expense, net | 663 | 365 |
| Net realized investment gain | (556) | (714) |
| Deferred income tax benefit | (724) | (8) |
| Net (increase) decrease in premiums receivable, prepaid reinsurance premiums and unearned premiums | 2,786 | (1,868) |
| Net increase in unpaid losses and loss adjustment expenses and reinsurance recoverable | 13,205 | 5,669 |
| Change in: | | |
| Accrued investment income | 114 | 225 |
| Deferred policy acquisition costs | (1,561) | 293 |
| Income tax payable | 1,718 | 1,562 |
| Other assets | (9) | 4 |
| Accounts payable and accrued expenses | (1,515) | (1,183) |
| Other liabilities | (3,020) | (1,879) |
| Net cash provided by operating activities | <u>15,759</u> | <u>6,040</u> |
| Cash flows from investing activities: | | |
| Purchases of equity securities | (20,667) | --- |
| Purchases of fixed maturities available for sale | (35,526) | (62,496) |
| Proceeds from sales of equity securities | 2,845 | 6,447 |
| Proceeds from sales of fixed maturities available for sale | 23,043 | 33,825 |
| Proceeds from maturities or calls of fixed maturities available for sale | 17,726 | 13,138 |
| Proceeds from maturities and calls of fixed maturities held to maturity | --- | 686 |
| Increase in payable for investment purchases | 1,040 | --- |
| Net cash used by investing activities | <u>(11,539)</u> | <u>(8,400)</u> |
| Cash flows from financing activities: | | |
| Issuance of common stock | 274 | 379 |
| Principal payments on capital lease obligations, affiliate | (42) | (39) |
| Dividends paid | (886) | (639) |
| Net cash used by financing activities | <u>(654)</u> | <u>(299)</u> |
| Increase (decrease) in cash and cash equivalents | 3,566 | (2,659) |
| Cash and cash equivalents, beginning of period | 11,976 | 9,796 |
| Cash and cash equivalents, end of period | <u>\$ 15,442</u> | <u>\$ 7,137</u> |

See accompanying Notes to Consolidated Financial Statements.

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Penn-America Group, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

Note 1 Organization and Basis of Presentation

Penn-America Group, Inc. (PAGI) is an insurance holding company. Penn Independent Corporation (Penn Independent) owned approximately 31% of the outstanding common stock of PAGI at March 31, 2004. The accompanying condensed unaudited consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States (GAAP) and 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). 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. The Company's results of operations for interim periods are not necessarily indicative of the results to be expected for the entire year. It is suggested that these condensed unaudited consolidated financial statements and notes be read in conjunction with the financial statements and notes in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

PAGI's wholly-owned business trust subsidiaries, Penn-America Statutory Trust I and Penn-America Statutory Trust II, are not consolidated pursuant to Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities*. The Company's business trust subsidiaries have issued \$30.0 million in floating rate capital securities (Trust Preferred Securities). PAGI guarantees all obligations of these business trust subsidiaries with respect to distributions and payments of the Trust Preferred Securities. The sole assets of the Company's business trust subsidiaries are junior subordinated debentures issued by the Company, which have the same terms with respect to maturity, payments and distributions as the Trust Preferred Securities.

Note 2 Reinsurance

Premiums earned are presented net of amounts ceded to reinsurers of \$8,629,000 and \$6,200,000 for the three months ended March 31, 2004 and 2003, respectively. Losses and loss adjustment expenses are presented net of amounts ceded to reinsurers of \$8,117,000 and \$3,869,000 for the three months ended March 31, 2004 and 2003, respectively.

As of March 31, 2004, the Company recorded a reinsurance recoverable of \$5,000,000 relating to a claim for an insured involving multiple policies written over multiple years beginning in 1998. The Company settled this claim in February 2004, but has not yet finalized the reinsurance recoverable with its reinsurer.

Note 3 Comprehensive Income

For the three months ended March 31, 2004, comprehensive income was \$5,844,000, which consisted of net income of \$4,658,000 and other comprehensive gain of \$1,186,000 related to a net unrealized gain on investments and an

unrealized loss on a cash flow hedging instrument. For the three months ended March 31, 2003, comprehensive income was \$3,372,000, which consisted of net income of \$3,574,000 and other comprehensive loss of \$202,000 related to net unrealized losses on investments and a cash flow hedging instrument.

Note 4 Net Income Per Share

Basic net income per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for each period. Diluted net income per share includes the potential dilution that could occur if outstanding contracts to issue common stock were exercised and converted to common stock. The following is a reconciliation of the basic and diluted net income per share computations:

| <i>(In thousands, except share data)</i> | Three months ended March 31, | |
|---|------------------------------|------------|
| | 2004 | 2003 |
| Basic per share computation: | | |
| Net income | \$ 4,658 | \$ 3,574 |
| Weighted average common shares outstanding | 14,753,594 | 14,591,096 |
| Basic net income per share | \$ 0.32 | \$ 0.24 |
| Diluted per share computation: | | |
| Net income | \$ 4,658 | \$ 3,574 |
| Weighted average common shares outstanding | 14,753,594 | 14,591,096 |
| Additional shares outstanding after the assumed exercise of options by applying the treasury stock method | 240,855 | 207,817 |
| Total shares | 14,994,449 | 14,798,913 |
| Diluted net income per share | \$ 0.31 | \$ 0.24 |

Note 5 Segment Information

The Company has one reportable segment that consists of its commercial property and casualty lines of business. In 1999, the Company exited the non-standard personal automobile line of business and announced that it would run-off its remaining portfolio of such business. For the three months ended March 31, 2004 and 2003, amounts relating to the non-standard personal automobile business were not material to the financial statements presented, and therefore, are not presented separately.

Note 6 Unpaid Losses and Loss Adjustment Expenses

The liability for losses and loss adjustment expenses represents the Company's best estimate of the ultimate amounts needed to pay both reported and unreported claims. These estimates are based on certain actuarial and other assumptions. 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.

The Company did not record any incurred losses and loss adjustment expenses attributable to events of prior years in the first quarter of 2004.

In 2003, the Company received an unexpected increase in the number of new claims reported relating to four policies issued to a single insured between January 1, 1980 and April 1, 1983. The insured was a manufacturer of safety equipment including industrial masks and the new claims reported allege existing and potential bodily injury due to a medical condition called silicosis. The original policies covered products and completed operations only and were issued with a \$500,000 indemnity policy aggregate limit of liability. At March 31, 2004, the Company's loss and loss adjustment expense reserves included its best estimate for its ultimate obligations for these claims based on current information.

Note 7 Commitments and Contingencies

The Company's insurance subsidiaries are subject to routine legal proceedings in connection with their property and casualty business. The Company is involved in no other pending or threatened legal or administrative proceedings which management believes might have a material adverse effect on the Company's financial condition or results of operations.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of Penn-America Group, Inc. ("PAGI") and subsidiaries (collectively "Penn-America" or the "Company") should be read in conjunction with the Company's Consolidated Financial Statements and related Notes included in Item 1, "Financial Information", of this report on Form 10-Q and the Company's Annual Report on Form 10-K for the year ended December 31, 2003. This discussion and analysis may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward looking statements are not statements of historical fact, and involve risks and uncertainties which could cause actual results to differ materially from those expected. The risks and uncertainties include, but are not limited to, those in the section entitled "Risk Factors" of the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

Overview

Business. PAGI is a specialty property and casualty insurance holding company that markets and underwrites general liability, commercial property and multi-peril insurance for small businesses with average annual premiums of about \$2,000. These small businesses are located primarily in small towns and rural areas in all fifty states and the District of Columbia. The small businesses Penn-America insures, such as restaurants, service contractors, retail stores and apartments, often cannot obtain insurance because of their rural locations, small premium size or non-standard risk characteristics. As a result, these small businesses must turn to companies like Penn-America, which operate in a small business niche of the secondary or residual market called the excess and surplus lines or E&S market. By operating in the E&S market, Penn-America is rewarded with higher prices than the standard lines market, more flexibility in excluding coverage for specific loss exposures and lower premium taxes and state guarantee fund assessments.

Penn-America distributes its insurance products through a small network of sixty-six (66) high-quality wholesale general agents who serve the needs of the more than 30,000 retail insurance brokers who work directly with Penn-America insureds. Penn-America has about one-half the number of general agents as its nearest competitor. By maintaining strong relationships with a small, select group of agents, a relationship with Penn-America offers true franchise value to each general agent by providing relative market exclusivity and a high level of service and support. The Company's distribution strategy has resulted in strong and consistent growth. From 1992 to 2003, the Company's commercial gross written premiums grew from \$22.6 million to \$209.4 million (a 22% annual compounded growth rate). Most of the growth was due to an increase in gross written premiums per agent from \$590,000 in 1992 to \$3.9 million in 2003.

Key Financial Measures. The Company utilizes a number of financial measures to evaluate its operating performance and financial condition. The Company's overall financial goal is to produce a 12 to 15 percent return on equity (ROE) over the long-term. For the twelve months ended March 31, 2004, ROE was 13.9 percent. The Company calculates ROE by dividing net income by average stockholders' equity. The following table summarizes ROE for each year in the ten-year period ended December 31, 2003:

| | Year ended December 31, | | | | | | | | | |
|------------------|-------------------------|-------|------|--------|------|------|-------|-------|-------|-------|
| | 2003 | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 | 1996 | 1995 | 1994 |
| Return on Equity | 13.5% | 11.8% | 6.4% | (6.3)% | 1.6% | 8.8% | 15.2% | 18.2% | 18.6% | 12.3% |

The Company's philosophy has been to distribute a portion of the ROE it generates through cash dividends to stockholders. Cash dividend per share increased to \$0.06 in the first quarter of 2004, compared with \$0.05375 in the fourth quarter of 2003 and \$0.04375 in the first quarter of 2003. Through March 31, 2004, the Company has paid cash dividends to stockholders in 36 consecutive quarters totaling over \$14.8 million.

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The remainder of the ROE generated by the Company is invested in growing the book value per share of the Company. Book value per share increased 3.9% in the first quarter of 2004 to \$9.22 from \$8.87 at December 31, 2003. Book value per share is calculated by dividing stockholders' equity by outstanding common shares.

The Company utilizes other financial measures to evaluate its operating performance, such as gross written premiums, operating income, GAAP underwriting income, GAAP combined ratio, net income and cash flows provided by operations. These additional financial measures are more fully described in Results of Operations and Liquidity and Capital Resources in this discussion and analysis.

This discussion and analysis consists of the following components:

- Results of Operations
- Critical Accounting Estimates and Policies
- Reinsurance
- Investments
- Liquidity and Capital Resources

Results of Operations for the Three Months Ended March 31, 2004 and 2003

Premiums earned increased 38.1% to \$47.5 million for 2004 compared with \$34.4 million for 2003 due to the growth in net written premiums over the last 12 months.

Gross written premiums, which represent the amount received or to be received for insurance policies written without reduction for acquisition costs, reinsurance costs or other deductions, increased 58.6% to \$64.1 million for 2004, compared with \$40.4 million for 2003. The increase was attributable to growth in new business and premium rate increases.

Ceded written premiums, the portion of gross written premiums reinsured by unaffiliated insurers, increased 34.2% to \$8.6 million for 2004 compared with \$6.4 million for 2003. The increase in ceded written premiums was due primarily to growth in gross written premiums partially offset by lower reinsurance rates on its multiple-line excess of loss reinsurance treaty. These lower rates are primarily due to an increase in Company's reinsurance retention on its property lines of business from \$300,000 per risk in 2003 to \$500,000 per risk in 2004.

Net written premiums, which are gross written premiums less ceded written premiums, increased 63.2% to \$55.5 million compared with \$34.0 million for 2003. The increase in net written premiums was slightly higher than the increase in gross written premiums due to lower reinsurance costs.

Net investment income increased to \$3.5 million for 2004 compared with \$3.2 million for 2003, due primarily to the growth in average invested assets, partially offset by a decrease in average yield on fixed-maturity investments.

Net realized investment gain was \$0.6 million for 2004 compared with \$0.7 million for 2003. The net realized investment gain for 2004 was primarily attributable to the sale of certain of the Company's fixed-maturity investments. The net realized investment gain for 2003 was primarily attributable to the sale of certain of the Company's fixed-maturity investments and all of the Company's then existing common stock investments.

Losses and loss adjustment expenses increased 37.4% to \$30.3 million for 2004 compared with \$22.0 million for 2003. The increase is primarily due to growth in premiums earned, as the loss ratio improved slightly to 63.7 for 2004 from 64.1 for 2003. The loss ratio is calculated by dividing losses and loss adjustment expenses by premiums earned.

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Amortization of deferred policy acquisition costs (ADAC) increased 35.6% to \$11.7 million for 2004 from \$8.6 million for 2003, primarily due to the growth in premiums earned.

Other underwriting expenses increased 1.4% to \$2.1 million for 2004 from \$2.0 million for 2003.

The overall GAAP combined ratio, which is the sum of the loss and expense ratios, improved to 92.7 for 2004 from 95.1 for 2003. The loss ratio improved to 63.7 for 2004 from 64.1 for 2003. The expense ratio, which is calculated by dividing the sum of ADAC and other underwriting expenses by premiums earned, improved to 29.0 for 2004 from 31.0 for 2003. 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 underwriting profitability.

Underwriting income increased to \$3.4 million for 2004 from \$1.7 million for 2003. Underwriting income is a non-GAAP financial measure used by the Company, among other measures, to evaluate the performance of its underwriting operations. Underwriting income is equal to premiums earned less losses and loss adjustment expenses, ADAC and other underwriting expenses. The improvement in underwriting income for 2004 was due to growth in earned premiums and improvement in the GAAP combined ratio.

Interest expense increased to \$0.5 million for 2004 from \$0.3 million for 2003, primarily due to interest expense on the Company's junior subordinated debentures issued in May, 2003.

Income tax expense increased to \$2.1 million for 2004 from \$1.6 million for 2003. This increase was due primarily to improved underwriting profitability.

Operating income increased to \$4.3 million or \$0.29 per share (basic and diluted) for 2004 from \$3.1 million or \$0.21 per share (basic and diluted) for 2003. Operating income is calculated by subtracting net realized investment gain, after taxes, from net income. Operating income is a non-GAAP financial measure used by the Company, among other measures, to evaluate its performance because the realization of net realized investment gains or losses in a given period is largely discretionary as to timing and could distort the comparability of results. The increase in operating income in 2004 was due to the improvement in underwriting income, after taxes, and growth of investment income, after taxes.

The factors described above resulted in net income for 2004 of \$4.7 million or \$0.32 per basic share and \$0.31 per diluted share, compared with \$3.6 million or \$0.24 per share (basic and diluted) for 2003.

Critical Accounting Estimates and Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

The Company has identified that the establishment of reserves for unpaid losses and loss adjustment expenses and the valuation of certain investments are critical accounting estimates because they involve a high degree of judgment. Although variability is inherent in these estimates, the Company believes the amounts provided in its financial statements are appropriate based upon the facts available at the time. For information related to the valuation of investments, see the section entitled "Investments" in this discussion and analysis beginning on page 15.

The Company is directly liable for losses and loss adjustment expenses under the terms of the insurance policies that it writes. In many cases, several years may lapse between the occurrence of an insured loss, the reporting of the loss to the Company and the Company's 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 the Company's ultimate loss. The estimate of the amount of the ultimate loss is based upon such factors as:

- the type of loss;
- jurisdiction of the occurrence;
- knowledge of the circumstances surrounding the claim;
- severity of injury or damage;

potential for ultimate exposure; and
policy provisions relating to the claim.

The Company determines loss adjustment expenses as a percentage of expected indemnity losses based on historical patterns adjusted to reflect current experience.

In addition to case reserves, management 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 determine its estimate of ultimate liability. The techniques recognize, among other factors:

- the Company's and the industry's experience;
- historical trends in reserving patterns and loss payments;
- the impact of claim inflation;
- the pending level of unpaid claims;
- the cost of claim settlements;
- the line of business mix; and
- 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 the emergence of new types of losses not sufficiently represented in the Company's historical experience or that 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. Changes in estimates for loss and loss adjustment expense reserves, as required by Statement of Financial Accounting Standards (SFAS) No. 60, Accounting and Reporting by Insurance Enterprises, are recorded in the period that the change in these estimates is made. The Company does not discount its loss reserves.

Unpaid losses and loss adjustment expenses increased 9.0% to \$190.6 million at March 31, 2004 from \$174.9 million at December 31, 2003. The Company did not record any incurred losses and loss adjustment expenses attributable to events of prior years in the first quarter of 2004.

In 2003, the Company received an unexpected increase in the number of new claims reported relating to four policies issued to a single insured between January 1, 1980 and April 1, 1983. The insured was a manufacturer of safety equipment including industrial masks and the new claims reported allege existing and potential bodily injury due to a medical condition called silicosis. The original policies covered products and completed operations only and were issued with a \$500,000 indemnity policy aggregate limit of liability. At March 31, 2004, the Company's loss and loss adjustment expense reserves included its best estimate for its ultimate obligations for these claims based on current information.

Reinsurance

Overview. To reduce its exposure to liability on individual risks and to protect against catastrophic losses, the Company purchases reinsurance through contracts called treaties or on a facultative basis. Reinsurance involves an insurance company transferring or ceding a portion of its exposure on a risk to another insurer (the reinsurer). The reinsurer assumes the exposure in return for a portion of the premium. The ceding of liability to a reinsurer does not legally discharge the primary insurer from its liability for the full amount of the policies on which it obtains reinsurance. The primary insurer will be required to pay the entire loss if the reinsurer fails to meet its obligations under the reinsurance agreement.

In formulating its reinsurance programs, the Company is selective in its choice of reinsurers and considers numerous factors, the most important of which are the financial stability of the reinsurer, its history of responding to claims and its overall reputation. In an effort to minimize its exposure to the insolvency of its reinsurers, the Company evaluates the acceptability and reviews the financial condition of each reinsurer annually. The Company's policy is to use only reinsurers that have an A.M. Best rating of A (Excellent) or better and that have at least \$500 million in statutory surplus.

The Company's principal reinsurance treaties include multiple-line excess of loss, umbrella quota share and property catastrophic loss.

Multiple-Line Excess of Loss. The Company's multiple-line excess of loss reinsurance treaty is placed with American Reinsurance Company (American Re), part of the Munich Re Group. American Re has an A.M. Best rating of A+ (Superior). The following is a summary of the Company's multiple-line excess of loss reinsurance treaty for 2004:

| Line of Business | Company Policy Limit | Reinsurance Coverage / Company Retention |
|------------------------------|----------------------------|---|
| Commercial property | \$2,000,000 per risk | \$1,500,000 per risk / \$4,500,000 per occurrence in excess of \$500,000 per risk |
| Commercial general liability | \$3,000,000 per occurrence | \$2,500,000 per occurrence in excess of \$500,000 per occurrence |

The Company's combined retention for any one loss resulting from a common occurrence involving both the commercial property and commercial general liability coverage on a single risk is \$500,000. The Company's multiple-line excess of loss treaty reinsurer also provides reinsurance coverage of \$10,000,000 per occurrence/aggregate for extra-contractual obligations, losses in excess of policy limits, loss adjustment expenses and liability resulting from two or more of the Company's insureds from the same occurrence.

Umbrella Quota Share. The Company offers umbrella liability policies up to \$5.0 million per occurrence. For policies where the Company writes the primary general liability, 90% of policy limits up to \$1.0 million per occurrence and 100% of policy limits up to \$4.0 million in excess of \$1.0 million per occurrence are reinsured with American Re. For policies where another insurer writes the primary general liability, 85% of policy limits up to \$1.0 million per occurrence, 90% of policy limits up to \$1.0 million in excess of \$1.0 million per occurrence and 100% of policy limits up to \$3.0 million in excess of \$2.0 million per occurrence are reinsured with American Re.

Property Catastrophic Loss. The Company maintains a catastrophic loss reinsurance program. As of January 1, 2004, the terms of this program provide for 100% retention of the first \$1.0 million per occurrence and reinsurance of 100% of \$29.0 million per occurrence in excess of \$1.0 million per occurrence.

For 2004, the Company's catastrophic loss reinsurance program includes: American Agricultural Insurance Company, Converium Reinsurance (North America) Inc., Converium (UK), Everest Reinsurance Company, Hannover Re (Bermuda) Ltd., PXRE Reinsurance Company, Shelter Reinsurance Company, Sirius International Insurance Corporation and XL Re Ltd. All of these reinsurers have statutory surplus greater than \$500 million and an A.M. Best rating of A (Excellent) or higher.

Reinsurance Recoverable. The Company's reinsurance recoverable increased to \$40.5 million as of March 31, 2004, compared with \$38.0 million as of December 31, 2003. This increase was due primarily to the growth in unpaid losses and loss adjustment expenses, which increased 9.0% to \$190.6 million as of March 31, 2004 from \$174.9 million at December 31, 2003. The following table summarizes the Company's outstanding reinsurance recoverable, net of a \$150,000 allowance for doubtful accounts, as of March 31, 2004, by reinsurer:

| <i>(Dollars in thousands)</i> | A.M Best Rating | Amount Reflected on Balance | Percentage of Reinsurance Recoverable |
|-------------------------------|---------------------|-----------------------------------|---|
| American Re | "A+" (Superior) | \$24,217 | 59.8% |
| General Re | "A++" (Superior) | 15,247 | 37.6 |
| Other reinsurers | --- | 1,036 | 2.6 |
| | | \$40,500 | 100.0% |

As of March 31, 2004, the Company recorded a reinsurance recoverable of \$5,000,000 relating to a claim for an insured involving multiple policies written over multiple years beginning in 1998. The Company settled this claim in February 2004, but has not yet finalized the reinsurance recoverable with its reinsurer.

Investments

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. The Company outsources the management of its investment portfolio to Gen Re New England Asset Management Inc. (NEAMS). In accordance with the asset management agreement between the Company and NEAMS, all investment transactions are approved by the Investment Committee of the Company within 60 days of their initiation by NEAMS.

Total cash and investments increased 5.3% to \$363.9 million at March 31, 2004 from \$345.7 million at December 31, 2003. This increase resulted primarily from net cash provided by operating activities of \$15.8 million for 2004. Total cash and investments of \$363.9 million at March 31, 2004 consisted of \$320.9 million in fixed-maturity securities, \$27.5 million in equity securities, consisting of preferred stocks, common stocks and a mutual fund invested in adjustable rate mortgages, and \$15.5 million in cash.

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The following summarizes the classifications of the Company's cash and investments at March 31, 2004:

| <i>(Dollars in thousands)</i> | Fair Value | Amount Reflected on Balance Sheet | Percentage of Cash and Investments |
|---|-------------------|---|--|
| Fixed maturities: | | | |
| Available for sale: | | | |
| U.S. Treasury securities and obligations of U.S. government agencies | \$ 17,613 | \$ 17,613 | 4.8% |
| Corporate securities | 95,825 | 95,825 | 26.3 |
| Mortgage-backed securities | 89,315 | 89,315 | 24.6 |
| Other-structured securities | 23,436 | 23,436 | 6.5 |
| Municipal securities | 94,380 | 94,380 | 25.9 |
| Total available for sale | 320,569 | 320,569 | 88.1 |
| Held to maturity: | | | |
| U.S. Treasury securities and obligations of U.S. government agencies | 26 | 25 | --- |
| Corporate securities | 265 | 250 | 0.1 |
| Total held to maturity | 291 | 275 | 0.1 |
| Total fixed-maturity securities | 320,860 | 320,844 | 88.2 |
| Equity securities | 27,507 | 27,507 | 7.5 |
| Cash | 15,542 | 15,542 | 4.3 |
| Total cash and investments | \$ 363,909 | \$ 363,893 | 100.0% |

The Company's fixed-maturity portfolio of \$320.9 million was 88.2% of the total cash and investments as of March 31, 2004. Of the fixed-maturity portfolio, 95.2% of the securities were rated A or better by Standard & Poor's. Standard & Poor's rates publicly traded securities in 20 categories ranging from AAA to CC. Securities with ratings from AAA to BBB- (the top ten categories) are commonly referred to as having an investment grade rating.

The quality of the fixed-maturity portfolio at March 31, 2004 was as follows:

| Standard and Poor's Rating | Percentage of Fixed-Maturity Portfolio |
|----------------------------|--|
| "AAA" | 57.7% |
| "AA" | 16.8 |
| "A" | 20.7 |
| "BBB" | 4.5 |
| Below "BBB" | 0.3 |
| | 100.0% |

As of March 31, 2004, the investment portfolio contained \$112.8 million of mortgage-backed, asset-backed and collateralized mortgage obligations. 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

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rates and the economic environment. The Company had no investments in real estate or mortgage loans in its investment portfolio as of March 31, 2004.

As of March 31, 2004, the Company's investment portfolio contained corporate fixed-maturities, common stocks and preferred stocks with a market value of \$118.3 million. A summary of these securities by industry segment was as follows:

| Industry Segment | Percentage of Corporate Fixed-Maturity, Common Stock and Preferred Stock Portfolio |
|------------------------|---|
| Consumer, non-cyclical | 26.3% |
| Financial institutions | 23.3 |
| Utilities | 17.9 |
| Communications | 10.4 |
| Consumer, cyclical | 8.0 |
| Industrial | 6.8 |
| Energy | 3.9 |
| Basic materials | 2.8 |
| Technology | 0.6 |
| | 100.0% |

The Company regularly evaluates its investment portfolio to identify other-than-temporary impairments of individual securities. The Company considers 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 following table contains an analysis of the Company's securities with gross unrealized losses, categorized by the period that the securities were in a continuous unrealized loss position as of March 31, 2004:

| <i>(Dollars in thousands)</i> | Number of | Fair Value | Book Value | Gross Unrealized Losses | | | |
|-------------------------------|--------------|---------------|---------------|-------------------------|---------------|------------------|-----------------|
| | | | | Total | Six Months | Between Seven | Greater than |

| Securities | | | | or Less | Months and One Year | One Year | |
|---------------------------|----|-----------|-----------|----------|------------------------------|-------------|-------|
| Fixed-maturity securities | 32 | \$ 33,938 | \$ 34,184 | \$ 246 | \$ 91 | \$ 134 | \$ 21 |
| Equity securities | 23 | 18,391 | 19,204 | 813 | 809 | 4 | -- |
| | | | | \$ 1,059 | \$ 900 | \$ 138 | \$ 21 |

As of March 31, 2004, the Company's fixed-maturity investment portfolio had thirty-two (32) securities with \$246,000 of gross unrealized losses. No single issuer had a gross unrealized loss position greater than \$25,000 or 2.5% of its original cost.

As of March 31, 2004, the Company held twenty-three (23) equity securities, consisting primarily of common stocks purchased by the Company in the first quarter of 2004.

Liquidity and Capital Resources

Capital Resources. PAGI is a holding company, the principal asset of which is the common stock of Penn-America Insurance Company. At March 31, 2004, PAGI's capital structure consisted of common stockholders' equity of \$136.1 million and junior subordinated debentures of \$30.0 million. The following table summarizes the capital resources:

| (In thousands) | March 31, 2004 | December 31, 2003 |
|--------------------------------|-------------------|-------------------------|
| Stockholders' equity | \$ 136,078 | \$ 130,810 |
| Junior subordinated debentures | 30,000 | 30,000 |
| Total capital | \$ 166,078 | \$ 160,810 |

Stockholders' equity increased 4.0% to \$136.1 million at March 31, 2004, compared with \$130.8 million at December 31, 2003 due primarily to net income of \$4.7 million for the first quarter of 2004.

The Company continually evaluates the adequacy and mix of its capital resources. The Company's strategy is to maintain capital at an adequate level to support its insurance operations, while achieving its 12% to 15% ROE financial goal over the long-term.

Liquidity. PAGI's principal source of cash to meet short-term and long-term liquidity needs, including the payment of dividends to stockholders, corporate expenses and interest on its junior subordinated debentures, is dividends from Penn-America Insurance Company. PAGI has no planned capital expenditures that could have an impact on its long-term liquidity needs.

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 dependent on the ability of Penn-America Insurance Company to pay dividends to PAGI.

The Company's insurance subsidiaries are restricted by statute as to the amount of dividends that they may pay without the prior approval of regulatory authorities. 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 surplus, or statutory net income for the prior year. Using these criteria, the available ordinary dividend for 2004 is \$12,196,000. For the three months ended March 31, 2004, there were no dividends paid by Penn-America Insurance Company to PAGI. Penn-America Insurance Company's ability to pay future dividends to PAGI without advance regulatory approval is dependent upon maintaining a positive level of unassigned and statutory surplus, which in turn, is dependent upon Penn-America Insurance Company and Penn-Star Insurance Company generating net income in excess of dividends to PAGI. As of March 31, 2004, Penn-America Insurance Company's statutory surplus was \$125,125,000, and included unassigned surplus of \$39,585,000.

Penn-America Insurance Company and Penn-Star Insurance Company are required by law to maintain a certain minimum level of statutory surplus. Statutory 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, 2003, the statutory 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 statutory surplus at December 31, 2003 was \$121,960,000 and its regulatory action level was \$30,034,000. Penn-Star Insurance Company's statutory surplus at December 31, 2003 was \$42,232,000 and its regulatory action level was \$11,256,000.

Net cash provided by operating activities increased to \$15.8 million for the three months ended March 31, 2004 from \$6.0 million for the three months ended March 31, 2003. This growth is due primarily to the increase of cash received from collections of premiums in excess of the increase of losses and loss adjustment expenses paid in 2004.

Net cash used by financing activities was \$654,000 for the three months ended March 31, 2004 as compared with \$299,000 for the three months ended March 31, 2003.

As a result of cash provided by operating activities, cash used by investing activities was \$11.5 million for the three months ended March 31, 2004, compared with \$8.4 million for the three months ended March 31, 2003.

The Company continually evaluates its short and long-term liquidity. The Company has generated positive cash flows from operations and acquired capital resources to support its liquidity. The Company believes that cash flows from operations and strategy of matching its investment maturities with liability durations will continue to support its short-term and long-term liquidity.

Contractual Obligations. The Company's contractual obligations have not materially changed from that identified at December 31, 2003.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market Risk

Market risk is the potential economic loss principally arising from adverse changes in the market value of financial instruments. The major component of market risk affecting the Company is interest rate risk related to its investment portfolio.

Interest Rate Risk. Interest rate risk is the Company's underlying exposure to an economic loss from changes in market interest rates. The Company's investment portfolio included fixed-maturity securities, preferred stocks and a mutual fund invested in adjustable rate mortgages with a market value of \$329.6 million at March 31, 2004 that is subject to interest rate risk. The Company manages its exposure to interest rate risk on investments 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 Company's liability and capital position.

The Company's market risk associated with exposure to interest rate risk has not materially changed from that identified at December 31, 2003.

Equity Price Risk. As of March 31, 2004 the Company's investments in equity securities consist of common stocks of \$18.7 million, preferred stocks of \$3.5 million and a mutual fund invested in adjustable rate mortgages of \$5.3 million. The market value of the Company's investments in preferred stocks and a mutual fund invested in adjustable rate mortgages totaling \$8.8 million are primarily affected by changes in interest rates. The Company's exposure to equity price risk is primarily attributable to its investments in common stocks of \$18.7 million, which were acquired in the first quarter of 2004.

The table below illustrates the sensitivity of the market value of the Company's investments in common stocks to selected hypothetical changes in market prices as of March 31, 2004. The selected scenarios are not predictions of future events, but rather illustrative of the effect that such events may have on the market value of the Company's investments in common stocks and stockholders' equity.

| <i>(Dollars in thousands)</i> | Estimated Market Value of Common Stocks | Estimated Change in Market Value | Hypothetical Percentage Increase (Decrease) in Stockholders Equity |
|-------------------------------|---|---|---|
| 20% price increase | \$ 22,463 | \$ 3,744 | 1.8% |
| 10% price increase | 20,591 | 1,872 | 0.9 |
| No change | 18,719 | -- | -- |
| 10% price decrease | 16,847 | (1,872) | (0.9) |
| 20% price decrease | 14,975 | (3,744) | (1.8) |

Item 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was performed under the supervision and with the participation of the Company's management, including the President and CEO and Senior Vice President, CFO and Treasurer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the President and CEO and Senior Vice President, CFO and Treasurer, concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

During the last fiscal quarter, there have been no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II

Item 1. Legal Proceedings None

Item 2. Changes in Securities and Use of Proceeds None

Item 3. Defaults Upon Senior Securities None

Item 4. Submission of Matters to a Vote by Security Holders - None

Item 5. Other Information None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

An Exhibit Index has been filed as part of this report on page E-1

(b) Reports on Form 8-K

On January 28, 2004, the Company filed a current report on Form 8-K announcing that the Company released its earnings for the fourth quarter and year end 2004.

On February 3, 2004, the Company filed a current report on Form 8-K announcing the availability of materials presented by Jon S. Saltzman, President and CEO and Joseph F. Morris, Sr. Vice President, CFO and Treasurer at the Eleventh Annual Emerald Groundhog Day Investment Forum.

On March 1, 2004, the Company filed a current report on Form 8-K announcing the availability of the Annual Statements for its insurance subsidiaries, Penn-America Insurance Company and Penn-Star Insurance Company, on the Company's web-site, in hard copy from the Company, or from the Pennsylvania Department of Insurance.

On March 31, 2004, the Company filed a current report on Form 8-K announcing the availability of the Combined Annual Statement for its insurance subsidiaries, Penn-America Insurance Company and Penn-Star Insurance Company, on the Company's web-site, in hard copy from the Company, or from the Pennsylvania Department of Insurance.

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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: May 7, 2004

By: /s/ Jon S. Saltzman
Jon S. Saltzman
President and
Chief Executive Officer

By: /s/ Joseph F. Morris
Joseph F. Morris
Senior Vice President,

Exhibit Index

| <u>Exhibit Number</u> | <u>Description of Exhibit</u> |
|---------------------------|---|
| 10.1 | Standard Executive Change-in-Control Employment Continuation Agreement. |
| 31.1 | Certification of Chief Executive Officer as adopted pursuant to Section 302(a) of Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer as adopted pursuant to Section 302(a) of Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer of Penn-America Group, Inc. dated May 7, 2004 in accordance with 18 U.S.C Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |