

Edgar Filing: HCC INSURANCE HOLDINGS INC/DE/ - Form 10-Q

HCC INSURANCE HOLDINGS INC/DE/  
Form 10-Q  
May 10, 2004

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q

- ☒ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarter Ended March 31, 2004.
- ☐ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-13790

HCC Insurance Holdings, Inc.

-----  
(Exact name of registrant as specified in its charter)

Delaware

76-0336636

-----  
(State or other jurisdiction of  
incorporation or organization)

(IRS Employer  
Identification No.)

13403 Northwest Freeway, Houston, Texas

77040-6094

-----  
(Address of principal executive offices)

(Zip Code)

(713) 690-7300

-----  
(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 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 ☐

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

On April 30, 2004, there were approximately 64.5 million shares of common stock, \$1.00 par value issued and outstanding.

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This report on Form 10-Q contains certain "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created by those laws. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as future capital expenditures, business strategy, competitive strengths, goals, growth of our business and operations, plans and references to future successes may be considered forward-looking statements. Also, when we use words such as "anticipate," "believe," "estimate," "expect," "intend," "plan," "probably" or similar expressions, we are making forward-looking statements. Many risks and uncertainties may impact the matters addressed in these forward-looking statements.

Many possible events or factors could affect our future financial results and performance. These could cause our results or performance to differ materially from those we express in our forward-looking statements. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of these assumptions, and therefore also the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements which are included in this report, our inclusion of this information is not a representation by us or any other person that our objectives and plans will be achieved.

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Our forward-looking statements speak only as of the date made and we will not update these forward-looking statements unless the securities laws require us to do so. In light of these risks, uncertainties and assumptions, any forward-looking events discussed in this report may not occur.

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### HCC Insurance Holdings, Inc. and Subsidiaries

#### Condensed Consolidated Balance Sheets

(unaudited, in thousands, except per share data)

|   | March 31, 2004 | December 31, 2003 |
|---|----------------|-------------------|
|   | -----          | -----             |
| ASSETS  |                |                   |
| Investments:  |                |                   |
| Fixed income securities, at market                              |                |                   |
| (cost: 2004 - \$1,236,538; 2003 - \$1,134,128)                  | \$ 1,275,619   | \$ 1,164,160      |
| Marketable equity securities, at market                         |                |                   |
| (cost: 2004 - \$16,369; 2003 - \$12,007)                        | 16,382         | 12,000            |
| Short-term investments, at cost, which approximates market      | 620,180        | 518,480           |
| Other investments, at cost, which approximates fair value       | 17,306         | 8,690             |
|   | -----          | -----             |
| Total investments   | 1,929,487      | 1,703,340         |
| Cash  | 25,382         | 96,410            |
| Restricted cash and cash investments                            | 182,009        | 210,300           |
| Premium, claims and other receivables                           | 1,007,745      | 899,030           |
| Reinsurance recoverables  | 967,483        | 916,190           |
| Ceded unearned premium  | 302,916        | 291,590           |
| Ceded life and annuity benefits                                 | 76,065         | 77,540            |
| Deferred policy acquisition costs                               | 122,471        | 106,940           |
| Goodwill  | 400,483        | 386,500           |
| Other assets  | 176,506        | 176,420           |
|   | -----          | -----             |
| TOTAL ASSETS  | \$ 5,190,547   | \$ 4,864,290      |
|   | =====          | =====             |
| LIABILITIES   |                |                   |
| Loss and loss adjustment expense payable                        | \$ 1,644,644   | \$ 1,535,280      |
| Life and annuity policy benefits                                | 76,065         | 77,540            |
| Reinsurance balances payable                                    | 298,786        | 296,910           |
| Unearned premium  | 649,060        | 592,310           |
| Deferred ceding commissions                                     | 86,880         | 88,120            |
| Premium and claims payable                                      | 814,663        | 745,550           |
| Notes payable   | 310,302        | 310,400           |
| Accounts payable and accrued liabilities                        | 206,926        | 171,220           |
|   | -----          | -----             |
| Total liabilities   | 4,087,326      | 3,817,370         |
| SHAREHOLDERS' EQUITY  |                |                   |
| Common stock, \$1.00 par value; 250.0 million shares authorized |                |                   |

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|   |              |              |
|---|--------------|--------------|
| (shares issued and outstanding: 2004 - 64,437; 2003 - 63,964) | 64,437       | 63,964       |
| Additional paid-in capital                                    | 458,753      | 447,671      |
| Retained earnings   | 548,892      | 509,151      |
| Accumulated other comprehensive income                        | 31,139       | 26,121       |
|   | -----        | -----        |
| Total shareholders' equity                                    | 1,103,221    | 1,046,923    |
|   | -----        | -----        |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY                    | \$ 5,190,547 | \$ 4,864,291 |
|   | =====        | =====        |

See Notes to Condensed Consolidated Financial Statements.

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## HCC Insurance Holdings, Inc. and Subsidiaries Condensed Consolidated Statements of Earnings (unaudited, in thousands, except per share data)

|  | For the three months ended<br>2004 |       |
|--|------------------------------------|-------|
|  | -----                              | ----- |
| REVENUE  |                                    |       |
| Net earned premium   | \$ 217,063                         | \$    |
| Fee and commission income  | 43,843                             |       |
| Net investment income  | 14,435                             |       |
| Net realized investment gain (loss)  | 518                                |       |
| Other operating income   | 2,159                              |       |
|  | -----                              | ----- |
| Total revenue  | 278,018                            |       |
| EXPENSE  |                                    |       |
| Loss and loss adjustment expense, net  | 125,864                            |       |
| Operating expense:   |                                    |       |
| Policy acquisition costs, net  | 43,219                             |       |
| Compensation expense   | 22,813                             |       |
| Other operating expense  | 15,379                             |       |
|  | -----                              | ----- |
| Total operating expense  | 81,411                             |       |
| Interest expense   | 2,212                              |       |
|  | -----                              | ----- |
| Total expense  | 209,487                            |       |
|  | -----                              | ----- |
| Earnings from continuing operations before income tax provision  | 68,531                             |       |
| Income tax provision from continuing operations  | 23,729                             |       |
|  | -----                              | ----- |
| Earnings from continuing operations  | 44,802                             |       |
| Earnings (loss) from discontinued operations, net of income taxes (benefit) of \$(146) in 2004 and \$740 in 2003 | (234)                              |       |
|  | -----                              | ----- |
| Net earnings   | \$ 44,568                          | \$    |

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## BASIC EARNINGS PER SHARE DATA:

|  |    |        |    |
|--|----|--------|----|
| Earnings from continuing operations          | \$ | 0.70   | \$ |
| Earnings (loss) from discontinued operations |    | (0.01) |    |

Net earnings

|    |      |    |
|----|------|----|
| \$ | 0.69 | \$ |
|----|------|----|

Weighted average shares outstanding

|        |
|--------|
| 64,249 |
|--------|

## DILUTED EARNINGS PER SHARE DATA:

|                                       |    |      |    |
|---------------------------------------|----|------|----|
| Earnings from continuing operations   | \$ | 0.68 | \$ |
| Earnings from discontinued operations |    | --   |    |

Net earnings

|    |      |    |
|----|------|----|
| \$ | 0.68 | \$ |
|----|------|----|

Weighted average shares outstanding

|        |
|--------|
| 65,416 |
|--------|

Cash dividends declared, per share

|    |       |    |
|----|-------|----|
| \$ | 0.075 | \$ |
|----|-------|----|

See Notes to Condensed Consolidated Financial Statements.

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## HCC Insurance Holdings, Inc. and Subsidiaries

### Condensed Consolidated Statements of Changes in Shareholders' Equity

For the three months ended March 31, 2004

(unaudited, in thousands, except per share data)

|  | Common<br>stock | Additional<br>paid-in<br>capital | Retained<br>earnings |    |
|--|-----------------|----------------------------------|----------------------|----|
| BALANCE AS OF DECEMBER 31, 2003  | \$ 63,964       | \$ 447,671                       | \$ 509,159           | \$ |
| Net earnings   | --              | --                               | 44,568               |    |
| Other comprehensive income   | --              | --                               | --                   |    |
| Comprehensive income   |                 |                                  |                      |    |
| 473 shares of common stock issued upon<br>exercise of options, including tax benefit of<br>\$1,631 | 473             | 11,082                           | --                   |    |
| Cash dividends declared, \$0.075 per share   | --              | --                               | (4,835)              |    |
| BALANCE AS OF MARCH 31, 2004   | \$ 64,437       | \$ 458,753                       | \$ 548,892           | \$ |

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(unaudited, in thousands, except per share data)

|  | For the three months ended M<br>2004 |    |
|--|--------------------------------------|----|
|  | -----                                |    |
| Cash flows from operating activities:  |                                      |    |
| Net earnings   | \$ 44,568                            | \$ |
| Adjustments to reconcile net earnings to net<br>cash provided by operating activities: |                                      |    |
| Change in premium, claims and other receivables  | (102,988)                            |    |
| Change in reinsurance recoverables   | (43,618)                             |    |
| Change in ceded unearned premium   | (8,366)                              |    |
| Change in loss and loss adjustment expense payable                                     | 93,623                               |    |
| Change in reinsurance balances payable   | 37                                   |    |
| Change in unearned premium   | 27,632                               |    |
| Change in premium and claims payable, net of restricted cash                           | 97,445                               |    |
| Depreciation and amortization expense  | 3,390                                |    |
| Other, net   | (10,858)                             |    |
|  | -----                                |    |
| Cash provided by operating activities  | 100,865                              |    |
| Cash flows from investing activities:  |                                      |    |
| Sales of fixed income securities   | 103,092                              |    |
| Maturity or call of fixed income securities  | 33,116                               |    |
| Sales of equity securities   | 300                                  |    |
| Change in short-term investments   | (59,045)                             |    |
| Cost of securities acquired  | (213,354)                            |    |
| Payments for purchase of subsidiaries, net of cash received                            | (43,307)                             |    |
| Other, net   | 2,266                                |    |
|  | -----                                |    |
| Cash used by investing activities  | (176,932)                            |    |
| Cash flows from financing activities:  |                                      |    |
| Issuance of notes payable, net of costs  | --                                   |    |
| Sale of common stock   | 9,924                                |    |
| Payments on notes payable  | (91)                                 |    |
| Dividends paid   | (4,800)                              |    |
|  | -----                                |    |
| Cash provided by financing activities  | 5,033                                |    |
|  | -----                                |    |
| Net change in cash   | (71,034)                             |    |
| Cash at beginning of period  | 96,416                               |    |
|  | -----                                |    |
| CASH AT END OF PERIOD  | \$ 25,382                            | \$ |
|  | =====                                |    |

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data)

## (1) GENERAL INFORMATION

HCC Insurance Holdings, Inc. and its subsidiaries ("we," "us" and "our") provide specialized property and casualty and accident and health insurance coverages and related agency services to commercial customers. Our lines of business include group life, accident and health; diversified financial products (which includes directors' and officers' liability, errors and omissions, employment practices liability and surety); our London market account (which includes energy, marine, property and accident and health); aviation; and other specialty lines of insurance. We operate primarily in the United States, the United Kingdom, Spain and Bermuda, although some of our operations have a broader international scope. We market our products both directly to customers and through a network of independent and affiliated agents and brokers.

### Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and include all adjustments which are, in our opinion, necessary for a fair presentation of the results of the interim periods. All adjustments made to the interim periods are of a normal recurring nature. The condensed consolidated financial statements include the accounts of HCC Insurance Holdings, Inc. and those of our wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated. The condensed consolidated financial statements for periods reported should be read in conjunction with the annual audited consolidated financial statements and related notes. The condensed consolidated balance sheet as of December 31, 2003 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. Included in 2003 net earnings is a charge of \$3.9 million, or \$0.06 per share, due to the cumulative effect on years prior to 2003 of our 2003 restatement to change our accounting for certain fee and commission income.

During the third quarter of 2003, we completed one acquisition. The results of operations of this entity are included in our consolidated financial statements beginning on the effective date of the transaction. Thus, our condensed consolidated statements of earnings and cash flows for the three months ended March 31, 2003 do not contain any activity generated by this entity.

### Income Tax

For the three months ended March 31, 2004 and 2003, the income tax provision has been calculated based on an estimated effective tax rate for each of the fiscal years. The difference between our effective tax rate and the United States federal statutory rate is primarily the result of state income taxes and tax exempt municipal bond interest.

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## Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

### (1) GENERAL INFORMATION, CONTINUED

#### Stock Options

We account for stock options granted to employees using the intrinsic value method of APB Opinion No. 25 entitled "Accounting for Stock Issued to Employees". All options have been granted at fixed exercise prices at the market price of our common stock at the grant date. Because of that, no stock-based employee compensation cost is reflected in our reported net income. However, the Financial Accounting Standards Board has issued an exposure draft of a pronouncement that, if adopted in its present form, will require stock-based employee compensation to be deducted from net income beginning in 2005. Options vest over a period of up to seven years and expire four to ten years after grant date. The following table illustrates the effects on net income and earnings per share if we had used the fair value method of SFAS No. 123 entitled "Accounting for Stock-Based Compensation".

|  | For the three months ended March 31,<br>2004 | 2003      |
|--|--|-----------|
|  | -----  | -----     |
| Reported net earnings  | \$ 44,568                                    | \$ 23,767 |
| Stock-based compensation using the fair value<br>method, net of income tax | (1,220)                                      | (1,939)   |
|  | -----  | -----     |
| Pro forma net earnings   | \$ 43,348                                    | \$ 21,828 |
|  | =====  | =====     |
| Reported basic earnings per share  | \$ 0.69                                      | \$ 0.38   |
| Fair value stock-based compensation  | (0.02)                                       | (0.03)    |
|  | -----  | -----     |
| Pro forma basic earnings per share   | \$ 0.67                                      | \$ 0.35   |
|  | =====  | =====     |
| Reported diluted earnings per share  | \$ 0.68                                      | \$ 0.38   |
| Fair value stock-based compensation  | (0.02)                                       | (0.04)    |
|  | -----  | -----     |
| Pro forma diluted earnings per share                                       | \$ 0.66                                      | \$ 0.34   |
|  | =====  | =====     |

#### Discontinued Operations

In December 2003, we sold the business of our retail brokerage subsidiary HCC Employee Benefits, Inc. In the fourth quarter of 2003, we began reporting this business as discontinued operations and prior year financial information has been reclassified to reflect this presentation. Summarized financial data for discontinued operations for the three months ended March 31, 2004 and 2003 is shown below. Earnings before income tax provision exclude allocated general corporate overhead expenses of \$0.4 million for 2003.

For the three months ended March 31,  
2004 2003



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|   | -----    | -----    |
|---|----------|----------|
| Revenue                                     | \$ (197) | \$ 4,449 |
| Earnings (loss) before income tax provision | (380)    | 2,167    |

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## HCC Insurance Holdings, Inc. and Subsidiaries

### Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

#### (1) GENERAL INFORMATION, CONTINUED

##### Reclassifications

Certain amounts in our 2003 condensed consolidated financial statements have been reclassified to conform to the 2004 presentation. Such reclassifications had no effect on our net earnings, shareholders' equity or cash flows.

#### (2) ACQUISITION

On January 31, 2004, we acquired all of the shares of Surety Associates Holding Co., Inc., the parent company of American Contractors Indemnity Company, a California surety company specializing in court, specialty contract, license and permit bonds. American Contractors Indemnity Company will further expand our diversified financial products segment. We paid \$46.9 million in cash. This business combination has been recorded using the purchase method of accounting. The results of operations of American Contractors Indemnity Company have been included in our consolidated financial statements beginning on the effective date of the transaction. We are still in the process of completing the purchase price allocation for this acquisition, as we are still gathering some of the information, including information related to litigation contingencies, needed to make the required calculations. Goodwill resulting from this acquisition will not be deductible for United States federal income tax purposes.

The following table summarizes the combined estimated fair values of assets acquired and liabilities assumed at the acquisition date.

|  | January 31, 2004 |
|--|------------------|
|  | -----            |
| Total investments                        | \$ 87,719        |
| Premium, claims and other receivables    | 5,726            |
| Reinsurance recoverables                 | 7,675            |
| Other policy related assets              | 14,477           |
| Goodwill and intangible assets           | 12,671           |
| All other assets                         | 6,033            |
|  | -----            |
| Total assets acquired                    | 134,301          |
| Loss and loss adjustment expense payable | 15,733           |
| Unearned premium                         | 29,117           |
| Other policy related liabilities         | 1,833            |
| All other liabilities                    | 40,709           |

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|                     |           |
|---------------------|-----------|
| Total liabilities   | 87,392    |
| Net assets acquired | \$ 46,909 |

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## HCC Insurance Holdings, Inc. and Subsidiaries

### Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

#### (2) ACQUISITION, CONTINUED

The following unaudited pro forma summary presents information as if this acquisition had occurred at the beginning of 2004 and 2003 after giving effect to certain adjustments, including amortization of intangible assets, presumed interest expense from debt issued to fund the acquisition and income taxes. The pro forma summary is for information purposes only, does not necessarily reflect the actual results that would have occurred, nor is it necessarily indicative of future results of the combined companies.

| Unaudited Pro forma Information | For the three months ended March 31, |           |
|---------------------------------|--------------------------------------|-----------|
|                                 | 2004                                 | 2003      |
| Revenue                         | \$282,352                            | \$210,035 |
| Net earnings                    | 44,988                               | 24,893    |
| Basic earnings per share        | 0.70                                 | 0.40      |
| Diluted earnings per share      | 0.69                                 | 0.39      |

#### (3) REINSURANCE

In the normal course of business our insurance companies cede a portion of their premium to non-affiliated domestic and foreign reinsurers through treaty and facultative reinsurance agreements. Although the ceding of reinsurance does not discharge the primary insurer from liability to its policyholder, our insurance companies participate in such agreements for the purpose of limiting their loss exposure, protecting them against catastrophic loss and diversifying their business. The following table represents the effect of such reinsurance transactions on premium and loss and loss adjustment expense:

|  | Written<br>Premium | Earned<br>Premium | Loss and L<br>Adjustme<br>Expense |
|--|--------------------|-------------------|-----------------------------------|
| For the three months ended March 31, 2004: |                    |                   |                                   |
| Direct business                            | \$ 371,961         | \$ 358,079        | \$ 211                            |
| Reinsurance assumed                        | 87,620             | 74,226            | 57                                |

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|                   |            |            |            |
|-------------------|------------|------------|------------|
| Reinsurance ceded | (223,626)  | (215,242)  | (143,000)  |
| NET AMOUNTS       | \$ 235,955 | \$ 217,063 | \$ 125,000 |

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## HCC Insurance Holdings, Inc. and Subsidiaries

### Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

#### (3) REINSURANCE, CONTINUED

|  | Written<br>Premium | Earned<br>Premium | Loss and Loss<br>Adjustment<br>Expense |
|--|--------------------|-------------------|--|
| For the three months ended March 31, 2003: |                    |                   |  |
| Direct business                            | \$ 296,780         | \$ 255,871        | \$ 167,216                             |
| Reinsurance assumed                        | 82,668             | 61,948            | 51,827                                 |
| Reinsurance ceded                          | (186,947)          | (155,397)         | (119,011)                              |
| NET AMOUNTS                                | \$ 192,501         | \$ 162,422        | \$ 100,032                             |

The table below represents the composition of reinsurance recoverables in our condensed consolidated balance sheets:

|   | March 31, 2004 | December 31, 2003 |
|---|----------------|-------------------|
| Reinsurance recoverable on paid losses                      | \$ 100,619     | \$ 443,069        |
| Reinsurance recoverable on outstanding losses               | 443,069        | 439,300           |
| Reinsurance recoverable on incurred but not reported losses | 439,300        | (15,505)          |
| Reserve for uncollectible reinsurance                       | (15,505)       |                   |
| TOTAL REINSURANCE RECOVERABLES                              | \$ 967,483     | \$ 867,864        |

Our insurance companies require their reinsurers not authorized by the respective states of domicile of our insurance companies to collateralize the reinsurance obligations due to us. The table below shows amounts held by us as collateral plus other credits available for potential offset.

|                        | March 31, 2004 | December 31, 2003 |
|------------------------|----------------|-------------------|
| Payables to reinsurers | \$ 433,872     | \$ 393,214        |

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|                   |            |            |
|-------------------|------------|------------|
| Letters of credit | 208,350    | 195,329    |
| Cash deposits     | 28,269     | 11,195     |
|                   | -----      | -----      |
| TOTAL CREDITS     | \$ 670,491 | \$ 599,738 |
|                   | =====      | =====      |

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## HCC Insurance Holdings, Inc. and Subsidiaries

### Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

#### (3) REINSURANCE, CONTINUED

The tables below present the calculation of net reserves, net unearned premium and net deferred policy acquisition costs:

|   | March 31, 2004 | December 31, |
|---|----------------|--------------|
|   | -----          | -----        |
| Loss and loss adjustment expense payable                    | \$ 1,644,644   | \$ 1,5       |
| Reinsurance recoverable on outstanding losses               | (443,069)      | (4           |
| Reinsurance recoverable on incurred but not reported losses | (439,300)      | (4           |
|   | -----          | -----        |
| NET LOSS AND LOSS ADJUSTMENT EXPENSE PAYABLE                | \$ 762,275     | \$ 7         |
|   | =====          | =====        |
| Unearned premium  | \$ 649,060     | \$ 5         |
| Ceded unearned premium                                      | (302,916)      | (2           |
|   | -----          | -----        |
| NET UNEARNED PREMIUM  | \$ 346,144     | \$ 3         |
|   | =====          | =====        |
| Deferred policy acquisition costs                           | \$ 122,471     | \$ 1         |
| Deferred ceding commissions                                 | (86,880)       | (            |
|   | -----          | -----        |
| NET DEFERRED POLICY ACQUISITION COSTS                       | \$ 35,591      | \$           |
|   | =====          | =====        |

We have a reserve of \$15.5 million as of March 31, 2004 for potential collectibility issues and associated expenses related to reinsurance recoverables. This includes the exposure we have with respect to disputed amounts. While we believe that the reserve is adequate based on currently available information, conditions may change or additional information might be obtained which may result in a future change in the reserve. We periodically review our financial exposure to the reinsurance market and the level of our reserve and continue to take actions in an attempt to mitigate our exposure to possible loss.

Certain reinsurers have delayed or suspended the payment of amounts recoverable under reinsurance contracts to which we are a party. Such delays have affected, although not materially to date, the investment income of our insurance companies, but not to any extent their liquidity. We limit our liquidity exposure by holding funds, letters of credit or other security such that net balances due are significantly less than the

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gross balances shown in our consolidated balance sheets. We generally expect to collect the full amounts recoverable and, if necessary, we may seek collection through judicial or arbitration proceedings.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

### (4) SEGMENT AND GEOGRAPHIC INFORMATION

The performance of each segment is evaluated based upon net earnings and is calculated after tax and after all corporate expense and purchase price allocations have been charged or credited to the individual segments. The following tables show information by business segment and geographic location. Geographic location is determined by physical location of our offices and does not represent the location of insureds or reinsureds from whom the business was generated. In December 2003, we sold our retail brokerage subsidiary that was a significant portion of our intermediary segment. As a result, operationally we have combined the underwriting agency and intermediary segments (excluding the former retail brokerage subsidiary, which is now shown as discontinued operations) to form the agency segment, and we have reflected this change in our 2003 presentation.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

### (4) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

|   | Insurance<br>Company | Agency    | Other<br>Operations |
|---|----------------------|-----------|---------------------|
| <hr/>                                     |                      |           |                     |
| For the three months ended March 31, 2004 |                      |           |                     |
| Revenue:                                  |                      |           |                     |
| Domestic                                  | \$ 189,901           | \$ 18,987 | \$ 2,154            |
| Foreign                                   | 53,796               | 12,782    | --                  |
| Inter-segment                             | --                   | 21,696    | --                  |
|   | <hr/>                |           |                     |
| TOTAL SEGMENT REVENUE                     | \$ 243,697           | \$ 53,465 | \$ 2,154            |
|   | <hr/>                |           |                     |

Inter-segment revenue

CONSOLIDATED TOTAL REVENUE

Net earnings:

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|          |    |        |    |       |    |       |
|----------|----|--------|----|-------|----|-------|
| Domestic | \$ | 24,630 | \$ | 6,896 | \$ | 1,193 |
| Foreign  |    | 8,890  |    | 5,191 |    | --    |

TOTAL SEGMENT NET EARNINGS (LOSS)

|    |        |    |        |    |       |
|----|--------|----|--------|----|-------|
| \$ | 33,520 | \$ | 12,087 | \$ | 1,193 |
|----|--------|----|--------|----|-------|

Inter-segment eliminations

Loss from discontinued operations

CONSOLIDATED NET EARNINGS

Other items:

|                               |    |        |    |       |    |     |
|-------------------------------|----|--------|----|-------|----|-----|
| Net investment income         | \$ | 13,353 | \$ | 840   | \$ | 89  |
| Depreciation and amortization |    | 811    |    | 2,435 |    | 126 |
| Interest expense (benefit)    |    | 348    |    | 2,040 |    | 190 |
| Capital expenditures          |    | 853    |    | 131   |    | 4   |

|                                |  |        |  |       |  |     |
|--------------------------------|--|--------|--|-------|--|-----|
| Income tax provision (benefit) |  | 15,722 |  | 8,200 |  | 418 |
|--------------------------------|--|--------|--|-------|--|-----|

Inter-segment eliminations

CONSOLIDATED INCOME TAX PROVISION FROM CONTINUING OPERATIONS

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

(4) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

|  | Insurance<br>Company | Agency  | Other<br>Operations | Co     |
|--|----------------------|---------|---------------------|--------|
| -----                                      |                      |         |                     |        |
| For the three months ended March 31, 2003: |                      |         |                     |        |
| Revenue:                                   |                      |         |                     |        |
| Domestic                                   | \$                   | 137,236 | \$                  | 11,040 |
| Foreign                                    |                      | 44,322  |                     | 6,898  |
| Inter-segment                              |                      | --      |                     | 26,994 |

TOTAL SEGMENT REVENUE

|    |         |    |        |    |     |    |
|----|---------|----|--------|----|-----|----|
| \$ | 181,558 | \$ | 44,932 | \$ | 447 | \$ |
|----|---------|----|--------|----|-----|----|

Inter-segment revenue

CONSOLIDATED TOTAL REVENUE

Net earnings:

|          |    |        |    |       |    |       |    |
|----------|----|--------|----|-------|----|-------|----|
| Domestic | \$ | 15,973 | \$ | 9,121 | \$ | (590) | \$ |
| Foreign  |    | 3,387  |    | 2,328 |    | --    |    |

TOTAL SEGMENT NET EARNINGS (LOSS)

|    |        |    |        |    |       |    |
|----|--------|----|--------|----|-------|----|
| \$ | 19,360 | \$ | 11,449 | \$ | (590) | \$ |
|----|--------|----|--------|----|-------|----|

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Inter-segment eliminations  
Earnings from discontinued operations

## CONSOLIDATED NET EARNINGS

### Other items:

|                                   |    |        |    |       |    |       |    |
|-----------------------------------|----|--------|----|-------|----|-------|----|
| Net investment income             | \$ | 10,030 | \$ | 932   | \$ | 4     | \$ |
| Depreciation and amortization (1) |    | 821    |    | 1,636 |    | 239   |    |
| Interest expense (benefit)        |    | 9      |    | 2,450 |    | 193   |    |
| Capital expenditures (1)          |    | 440    |    | 748   |    | --    |    |
| Income tax provision (benefit)    |    | 8,761  |    | 7,274 |    | (282) |    |
| Inter-segment eliminations        |    |        |    |       |    |       |    |

## CONSOLIDATED INCOME TAX PROVISION FROM CONTINUING OPERATIONS

(1) Excludes immaterial amounts related to discontinued operations.

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## HCC Insurance Holdings, Inc. and Subsidiaries

### Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

### (4) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

The following tables present selected revenue items by line of business for the periods indicated:

|                                   | For the three months ended March 31, |            |
|-----------------------------------|--------------------------------------|------------|
|                                   | 2004                                 | 2003       |
|                                   | -----                                | -----      |
| Group life, accident and health   | \$ 79,389                            | \$ 71,983  |
| Diversified financial products    | 56,399                               | 18,306     |
| London market account             | 26,114                               | 29,376     |
| Aviation                          | 24,269                               | 23,882     |
| Other specialty lines of business | 12,571                               | 54         |
|                                   | -----                                | -----      |
|                                   | 198,742                              | 143,601    |
| Discontinued lines of business    | 18,321                               | 18,821     |
|                                   | -----                                | -----      |
| NET EARNED PREMIUM                | \$ 217,063                           | \$ 162,422 |
|                                   | =====                                | =====      |
| Group life, accident and health   | \$ 12,992                            | \$ 15,479  |
| Property and casualty             | 30,851                               | 10,173     |
|                                   | -----                                | -----      |
| FEE AND COMMISSION INCOME         | \$ 43,843                            | \$ 25,652  |
|                                   | =====                                | =====      |

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

## (5) EARNINGS PER SHARE

Basic earnings per share is based on the weighted average number of common shares outstanding during the period divided into net earnings. Diluted earnings per share is based on the weighted average number of common shares outstanding plus the potential common shares outstanding during the period divided into net earnings. Outstanding common stock options, when dilutive, are considered to be potential common shares for the purpose of the diluted calculation. The treasury stock method is used to calculate potential common shares due to options. Contingent shares to be issued are included in the earnings per share computation when the underlying conditions for issuance have been met.

The following table provides a reconciliation of the denominators used in the earnings per share calculations:

|  | For the three months<br>2004 |
|--|------------------------------|
|  | -----                        |
| Net earnings   | \$ 44,568                    |
|  | =====                        |
| Weighted average common shares outstanding   | 64,249                       |
| Additional dilutive effect of outstanding options<br>(as determined by the application of the treasury stock method) | 1,167                        |
|  | -----                        |
| Weighted average common shares and potential<br>common shares outstanding  | 65,416                       |
|  | =====                        |
| Anti-dilutive shares not included in computation   | --                           |
|  | =====                        |

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

## (6) SUPPLEMENTAL INFORMATION

Supplemental information for the three months ended March 31, 2004 and 2003, is summarized below:

| 2004  | 2003  |
|-------|-------|
| ----- | ----- |



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|   |    |        |    |        |
|---|----|--------|----|--------|
| Interest paid   | \$ | 3,270  | \$ | 2,431  |
| Income tax paid   |    | 31,558 |    | 5,931  |
| Comprehensive income                                    |    | 49,581 |    | 22,944 |
| Ceding commissions netted with policy acquisition costs |    | 29,892 |    | 24,379 |

### (7) COMMITMENTS AND CONTINGENCIES

We are party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which we believe have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits, arbitrations and other proceedings which relate to disputes over contractual relationships with third parties, or which involve alleged errors and omissions on the part of our subsidiaries. A subsidiary has been named along with several other defendants in legal proceedings by certain of the insurance company members of a discontinued workers' compensation reinsurance facility commonly known as the Unicover Pool. During 1997 and 1998, our subsidiary was one of two co-intermediaries for the facility. Other defendants in the current proceedings include the other reinsurance intermediary, the former managing underwriter for the facility and various individuals, none of whom are affiliated with us. It is claimed in the proceedings that the actions of the various defendants resulted in the rescission of certain reinsurance contracts in an arbitration to which we were not a party and include allegations of breach of fiduciary duty, negligence, fraud and other allegations. The claims in the proceedings are for unspecified or substantial compensatory and punitive damages. We believe that we have meritorious defenses to the allegations and intend to vigorously defend against the claims made in the proceedings. In addition, we are presently engaged in litigation initiated by the appointed liquidator of a former reinsurer concerning payments made to us prior to the date of the appointment of the liquidator. The disputed payments were made by the now insolvent reinsurer in connection with a commutation agreement. Our understanding is that such litigation is one of a number of similar actions brought by the liquidator. We intend to vigorously contest the action. Although the ultimate outcome of these matters may not be determined at this time, based upon present information, the availability of insurance coverage and legal advice received, we do not believe the resolution of any of these matters, some of which include allegations of damages in material amounts, will have a material adverse effect on our financial condition, results of operations or cash flows.

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

### Overview

We primarily receive our revenue from earned premium derived from our insurance company operations, fee and commission income generated by our agency operations, proceeds from ceded reinsurance (ceding commissions in excess of acquisition costs) earned by our insurance company subsidiaries, investment income from all of our operations and other operating income. Our core underwriting activities involve providing group life, accident and health, diversified financial products, London market account, aviation and other specialty lines of business, each of which is marketed by our insurance companies and our agencies either directly to customers or through a network of agents, third party administrators and brokers.

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The results of operations of Surety Associates Holding Co., Inc. and its subsidiary American Contractors Indemnity Company, which were acquired in the first quarter of 2004, and Covenant Underwriters Limited and Continental Underwriters Limited, which were acquired in the third quarter of 2003, are included in our condensed consolidated financial statements beginning on the effective date of their acquisition. Thus, our condensed consolidated statements of earnings and cash flows for the three months ended March 31, 2003 do not include the operations of these companies. Amounts related to these acquired subsidiaries included in our 2004 condensed consolidated statement of earnings include revenue of \$9.6 million and net earnings of \$0.9 million.

### Results of Operations

The following table sets forth the relationships of certain income statement items as a percent of total revenue for the three months ended March 31, 2004 and 2003:

|                                       | 2004  | 2003  |
|---------------------------------------|-------|-------|
|                                       | ----- | ----- |
| Net earned premium                    | 78.1% | 81.2% |
| Fee and commission income             | 15.7  | 12.8  |
| Net investment income                 | 5.2   | 5.5   |
| Net realized investment gain          | 0.2   | --    |
| Other operating income                | 0.8   | 0.5   |
|                                       | ----- | ----- |
| Total revenue                         | 100.0 | 100.0 |
| Loss and loss adjustment expense, net | 45.3  | 50.0  |
| Total operating expense               | 29.3  | 31.9  |
| Interest expense                      | 0.8   | 0.9   |
|                                       | ----- | ----- |
| Earnings from continuing operations   |       |       |
| before income tax provision           | 24.6  | 17.2  |
| Income tax provision                  | 8.5   | 6.0   |
|                                       | ----- | ----- |
| Earnings from continuing operations   | 16.1% | 11.2% |
|                                       | ===== | ===== |

Three months ended March 31, 2004 versus three months ended March 31, 2003

Total revenue increased 39% to \$278.0 million for 2004 driven by significant increases in net earned premium, fee and commission income and investment income. Most of this growth was organic as only a relatively small amount, \$9.6 million, came from subsidiaries acquired in the past year. We expect revenue growth to continue in 2004 and into 2005.

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Fee and commission income increased 71% to \$43.8 million in 2004 due principally to organic growth in our agency subsidiaries. Additionally, 2003 fee and commission income included a charge of \$6.5 million due to the cumulative effect on years prior to 2003 of our 2003 restatement to change our accounting for certain fee and commission income. The table below shows the composition of fee and commission income for the three months ended March 31, 2004 and 2003 (amounts in thousands):

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|  | 2004      | 2003      |
|--|-----------|-----------|
|  | -----     | -----     |
| Continuing subsidiaries, excluding 2003 charge | \$ 42,055 | \$ 32,180 |
| Subsidiaries acquired during past year         | 1,788     | --        |
| 2003 charge                                    | --        | (6,528)   |
|  | -----     | -----     |
| Total fee and commission income                | \$ 43,843 | \$ 25,652 |
|  | =====     | =====     |

Net investment income increased 31% to \$14.4 million in 2004. This increase was due to higher investment assets, which increased to \$1.9 billion as of March 31, 2004 compared to \$1.7 billion as of December 31, 2003 and \$1.3 billion as of March 31, 2003, resulting from significant cash flow from operations and the acquisition of American Contractors Indemnity Company in January 2004. Net investment income increased despite low yields on our fixed income and short-term investments. We expect investment assets to continue to increase and produce additional growth in investment income in 2004. If market interest rates were to rise, the growth in investment income would be expected to accelerate as our current portfolio has a relatively short duration and would become available to be invested on a longer-term basis to take advantage of higher rates. Our weighted average tax equivalent yield was 3.7% in 2004 and 3.9% in 2003. As of March 31, 2004, the weighted average duration of our fixed income portfolio was 3.96 years and the weighted average maturity was 4.76 years.

Compensation expense increased as staffing levels have increased from the prior year. However, the increase in compensation is not as great as the increase in revenue resulting in higher margins and increased net earnings. Compensation expense for the three months ended March 31, 2004 and 2003 (amounts in thousands) and the number of employees as of March 31 of each year are shown below:

|  | 2004      | 2003      |
|--|-----------|-----------|
|  | -----     | -----     |
| Continuing subsidiaries                | \$ 20,970 | \$ 18,746 |
| Subsidiaries acquired during past year | 1,843     | --        |
|  | -----     | -----     |
| Total compensation expense             | \$ 22,813 | \$ 18,746 |
|  | =====     | =====     |

|  | 2004  | 2003  |
|--|-------|-------|
|  | ----- | ----- |
| Continuing subsidiaries                | 1,119 | 1,052 |
| Subsidiaries acquired during past year | 176   | --    |
| Subsidiaries sold during past year     | --    | 54    |
|  | ----- | ----- |
| Total number of employees              | 1,295 | 1,106 |
|  | ===== | ===== |

Other operating expense increased during 2004 compared to 2003, principally as a result of acquisitions made in 2004 and 2003.

Interest expense was \$2.2 million in 2004 compared to \$1.7 million in 2003. The

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increase is due to interest on our 1.3% convertible notes, which were issued on March 31, 2003.

Income tax expense from continuing operations was \$23.7 million in 2004 compared to \$12.1 million in 2003. Our effective tax rate was 34.6% in 2004 compared to 35.1% in 2003. We expect an incremental decrease to our income tax rate in 2004 compared to 2003 as a higher percentage of our expected pre-tax income will not be subject to U.S. state income taxes.

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Net earnings increased 88% to \$44.6 million, or \$0.68 per diluted share, in 2004 from \$23.8 million, or \$0.38 per diluted share, in 2003. Growth in net earned premium, fee and commission income and investment income and continuing favorable underwriting results increased 2004 net earnings. Also included in 2003 net earnings is a charge of \$3.9 million, or \$0.06 per share, due to the cumulative effect on years prior to 2003 of our 2003 restatement to change our accounting for certain fee and commission income.

At March 31, 2004, total assets were \$5.2 billion, shareholders' equity was \$1.1 billion and book value per share was \$17.12, up from \$16.37 as of December 31, 2003.

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### SEGMENTS

#### Insurance Companies

The following table sets forth certain premium revenue information for the three months ended March 31, 2004 and 2003 (amounts in thousands):

|                            | 2004       | 2003       |
|----------------------------|------------|------------|
|                            | -----      | -----      |
| Direct                     | \$ 371,961 | \$ 296,780 |
| Reinsurance assumed        | 87,620     | 82,668     |
|                            | -----      | -----      |
| Gross written premium      | 459,581    | 379,448    |
| Reinsurance ceded          | (223,626)  | (186,947)  |
|                            | -----      | -----      |
| Net written premium        | 235,955    | 192,501    |
| Change in unearned premium | (18,892)   | (30,079)   |
|                            | -----      | -----      |
| Net earned premium         | \$ 217,063 | \$ 162,422 |
|                            | =====      | =====      |

The following tables provide information by line of business (amounts in thousands):

| Gross<br>written<br>premium | Percentage<br>change from<br>prior year | Net<br>written<br>premium | Percenta<br>change f<br>prior ye |
|-----------------------------|---|---------------------------|----------------------------------|
| -----                       | -----                                   | -----                     | -----                            |

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For the three months ended March 31, 2004:

|                                   |            |       |            |       |
|-----------------------------------|------------|-------|------------|-------|
| Group life, accident and health   | \$ 146,654 | 5%    | \$ 77,967  | 2%    |
| Diversified financial products    | 170,866    | 59    | 71,508     | 115   |
| London market accounts            | 56,700     | (7)   | 32,717     | (12)  |
| Aviation                          | 43,133     | (3)   | 20,950     | 1     |
| Other specialty lines of business | 31,020     | nm    | 18,905     | nm    |
|                                   | -----      | ----- | -----      | ----- |
|                                   | 448,373    | 27    | 222,047    | 33    |
| Discontinued lines of business    | 11,208     | nm    | 13,908     | nm    |
|                                   | -----      | ----- | -----      | ----- |
| TOTALS                            | \$ 459,581 | 21%   | \$ 235,955 | 23%   |
|                                   | =====      | ===== | =====      | ===== |

For the three months ended March 31, 2003:

|                                   |            |            |
|-----------------------------------|------------|------------|
| Group life, accident and health   | \$ 139,320 | \$ 76,185  |
| Diversified financial products    | 107,320    | 33,307     |
| London market accounts            | 60,718     | 37,232     |
| Aviation                          | 44,531     | 20,679     |
| Other specialty lines of business | 1,464      | 39         |
|                                   | -----      | -----      |
|                                   | 353,353    | 167,442    |
| Discontinued lines of business    | 26,095     | 25,059     |
|                                   | -----      | -----      |
| TOTALS                            | \$ 379,448 | \$ 192,501 |
|                                   | =====      | =====      |

nm - Not meaningful.

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Gross written premium increased 21% to \$459.6 million in the first quarter of 2004. Net written premium increased 23% to \$236.0 million and net earned premium increased 34% to \$217.1 million, both due principally to the growth in gross written premium and increased retentions in some areas. The increase in premium is expected to continue throughout 2004 and into 2005. The growth in gross written premium results principally from the following factors:

- The largest growth was in our diversified financial products line of business. Within this line of business, directors' and officers' liability and professional indemnity insurance written in the United States and internationally continued to show accelerated growth due to higher premium rates, increased new business and higher renewal percentages. Surety business increased due to our acquisition of American Contractors Indemnity Company on January 31, 2004.
- Our other specialty lines of business also increased significantly due to new business activities commenced during the past year. These activities include underwriting of marine insurance on the Gulf Coast of the United States, our quota-share reinsurance participation in a book of surplus lines insurance and our participation in a Lloyds syndicate writing UK liability insurance.
- Our London market account experienced somewhat reduced premium writings due to more selective underwriting of property business, particularly risks located in the United States, as premium rates softened.
- We recently determined to cease writing certain accident and health

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reinsurance business previously included in our other specialty lines of business. Amounts related to this business, which are now included in our discontinued lines of business, are gross written premium of \$11.5 million in 2004 and \$19.4 million in 2003; net written premium of \$12.0 million in 2004 and \$17.4 million in 2003; and net earned premium of \$15.3 million in 2004 and \$9.5 million in 2003. This business is expected to run off profitably.

The table below shows the composition of net incurred loss and loss adjustment expense for the three months ended March 31, 2004 and 2003 (amounts in thousands):

|   | 2004       |            | 2003       |            |
|---|------------|------------|------------|------------|
|   | Amount     | Loss Ratio | Amount     | Loss Ratio |
| Deficiency  | \$ 2,153   | 1.0%       | \$ 1,295   | 0.8%       |
| All other incurred loss and loss adjustment expense | 123,711    | 57.0       | 98,737     | 60.8       |
| Net incurred loss and loss adjustment expense       | \$ 125,864 | 58.0%      | \$ 100,032 | 61.6%      |

Our net loss and loss expense deficiency was \$2.2 million for 2004 compared to a deficiency of \$1.3 million in 2003. We continue to benefit from disciplined underwriting in a hard insurance market. We have no material exposure to environmental or asbestos losses and believe we have provided for all material net incurred losses. Our gross loss ratio was 62.2% for 2004 compared to 68.9% for 2003. During the first quarter of 2003, we increased gross losses by \$15.0 million on certain accident and health business included in the discontinued line of business. This had the effect of increasing our gross loss ratio by 4.7%. Since these contracts were substantially reinsured, the effect on our net losses was not material.

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The following table provides comparative net loss ratios by line of business for the three months ended March 31, 2004 and 2003 (amounts in thousands):

|                                   | 2004               |                | 2003               |                |
|-----------------------------------|--------------------|----------------|--------------------|----------------|
|                                   | Net earned premium | Net loss ratio | Net earned premium | Net loss ratio |
| Group life, accident and health   | \$ 79,389          | 62.9%          | \$ 71,983          | 63.6%          |
| Diversified financial products    | 56,399             | 46.3           | 18,306             | 43.7           |
| London market accounts            | 26,114             | 29.6           | 29,376             | 42.2           |
| Aviation                          | 24,269             | 62.5           | 23,882             | 65.5           |
| Other specialty lines of business | 12,571             | 61.2           | 54                 | 44.4           |
|                                   | 198,742            | 53.6           | 143,601            | 57.0           |

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|                                |           |       |           |       |
|--------------------------------|-----------|-------|-----------|-------|
| Discontinued lines of business | 18,321    | 105.2 | 18,821    | 96.8  |
|                                | -----     | ----- | -----     | ----- |
| TOTALS                         | \$217,063 | 58.0% | \$162,422 | 61.6% |
|                                | =====     |       | =====     |       |
| Expense ratio                  |           | 25.3  |           | 27.2  |
|                                |           | ----- |           | ----- |
| Combined ratio                 |           | 83.3% |           | 88.8% |
|                                |           | ===== |           | ===== |

Comments on significant changes in the comparative net loss ratios by line of business are attributed to the following:

- London market accounts -- Underwriting results generally improved in this line of business. Both quarters have been affected by reserve redundancies following our ongoing review of outstanding claims.
- Other specialty lines -- The current loss activity reflected is as expected and is due to new business activities commenced during the past year.
- Discontinued lines of business -- Both years have been affected by reserve additions resulting from our ongoing review of outstanding claims. Additionally, given the limited amount of earned premium on this line of business, a minor adjustment to the reserves can significantly impact the loss ratio.

Policy acquisition costs, which are net of the related portion of commissions on reinsurance ceded, increased to \$43.2 million during the first quarter of 2004, from \$32.0 million in the same period in 2003. This increase is due to and proportional to the increase in net earned premium. Although operating expenses increased as our revenues expanded, they increased in a smaller percentage than revenues and thus our expense ratio declined from 27.2% in 2003 to 25.3% in 2004.

Net earnings of our insurance companies increased 73% to \$33.5 million in 2004 due to increased premium volume, continuing profitable underwriting results, a lower expense ratio and increased investment income. We expect this growth to continue through 2005. Our increasingly profitable underwriting results are reflected in a 2004 combined ratio of 83.3% compared to 88.8% in 2003.

### Agency

Revenue from our agency segment increased 19% to \$53.5 million in 2004. This results primarily from higher premium rates, increased new business and higher renewal percentages. Subsidiaries acquired during 2003 accounted for \$2.5 million of the increased revenue. Net earnings of our agency segment increased 6% to \$12.1 million in 2004 for the same reasons. Higher corporate cost allocations in 2004 caused the increase in segment net earnings to be less than the comparable increase in segment revenue. We expect continued improvement in this segment during the remainder of 2004.

### Other Operations

The increase in the revenue in this segment in 2004 is primarily due to income from strategic investments and securities trading activities. Quarter to quarter comparisons may vary substantially depending on other operating investments or dispositions of such investments in any given period.

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### Liquidity and Capital Resources

We receive substantial cash from premiums, reinsurance recoverables, fee and commission income and, to a lesser extent, investment income and proceeds from sales and redemptions of investments and other assets. Our principal cash outflows are for the payment of claims and loss adjustment expenses, payment of premiums to reinsurers, purchases of investments, debt service, policy acquisition costs, operating expenses, income and other taxes and dividends. Variations in operating cash flows can occur due to timing differences in either the payment of claims and the collection of related recoverables or the collection of receivables and the payment of related payable amounts.

We maintain a substantial level of cash and liquid short-term investments which are used to meet anticipated payment obligations. Our consolidated cash and investment portfolio increased \$155.1 million, or 9%, during the first quarter of 2004 and totaled \$2.0 billion as of March 31, 2004, of which \$645.6 million was cash and short-term investments. The increase resulted primarily from operating cash flows and the acquisition of American Contractors Indemnity Company. During the first quarter of 2004, due primarily to changes in market interest rates, the net after tax unrealized gain on our investments recorded in other comprehensive income increased \$7.9 million. However, during the month of April we estimate that our net after tax unrealized gain decreased approximately \$14.8 million, again primarily due to changes in market interest rates.

We have filed registration statements with the United States Securities and Exchange Commission, which provide shelf registrations for an aggregate of \$750.0 million of our securities, of which we have \$625.0 million available to be issued. These securities may be debt securities, equity securities or a combination thereof.

Notes payable as of March 31, 2004 and December 31, 2003 are shown in the table below (amounts in thousands):

|                        | 2004       | 2003       |
|------------------------|------------|------------|
|                        | -----      | -----      |
| 1.3% Convertible notes | \$ 125,000 | \$ 125,000 |
| 2% Convertible notes   | 172,451    | 172,451    |
| Other debt             | 12,851     | 12,953     |
|                        | -----      | -----      |
| Total notes payable    | \$ 310,302 | \$ 310,404 |
|                        | =====      | =====      |
| Debt to total capital  | 22.0%      | 22.9%      |
|                        | =====      | =====      |

Our \$200.0 million Revolving Loan Facility, which had no outstanding borrowings as of March 31, 2004, expires on December 17, 2004. We expect to replace the facility with another facility.

Holders of our 2% Convertible Notes due in 2021 may require us to repurchase the notes at par on September 1, 2004. Because the recent market price of these notes (\$114.25 as of March 31, 2004) is significantly in excess of the par value, we do not expect that a significant portion of the notes will be tendered for repurchase. In the event that any such notes are tendered for repurchase we would expect to use funds from our revolving loan facility to repurchase the



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notes for cash.

The following table shows the composition of our gross, ceded and net reserves at the respective balance sheet dates (amounts in thousands):

|  | Gross<br>----- | Ceded<br>----- |
|--|----------------|----------------|
| As of March 31, 2004:                          |                |                |
| Reported losses                                | \$ 864,182     | \$ 443,069     |
| Incurred but not reported loss                 | 780,462        | 439,300        |
|  | -----          | -----          |
| Total loss and loss adjustment expense payable | \$ 1,644,644   | \$ 882,369     |
|  | =====          | =====          |
| As of December 31, 2003:                       |                |                |
| Reported losses                                | \$ 791,322     | \$ 425,609     |
| Incurred but not reported loss                 | 743,966        | 404,479        |
|  | -----          | -----          |
| Total loss and loss adjustment expense payable | \$ 1,535,288   | \$ 830,088     |
|  | =====          | =====          |

Reserves and recoverables continue to grow primarily due to our large account directors' and officers' liability business. These claims have a longer duration and tend to be more highly reinsured than our other lines of business due to their potential volatility.

We have a reserve of \$15.5 million as of March 31, 2004 for potential collectibility issues and associated expenses related to reinsurance recoverables. This includes the exposure we have with respect to disputed amounts. While we believe that the reserve is adequate based on currently available information, conditions may change or additional information might be obtained which may result in a future change in the reserve. We periodically review our financial exposure to the reinsurance market and the level of our reserve and continue to take actions in an attempt to mitigate our exposure to possible loss.

Certain reinsurers have delayed or suspended the payment of amounts recoverable under reinsurance contracts to which we are a party. Such delays have affected, although not materially to date, the investment income of our insurance companies, but not to any extent their liquidity. We limit our liquidity exposure by holding funds, letters of credit or other security such that net balances due are significantly less than the gross balances shown in our consolidated balance sheets. We generally expect to collect the full amounts recoverable and, if necessary, we may seek collection through judicial or arbitration proceedings.

We believe that our operating cash flows, short-term investments, bank facility and shelf registrations on file with the United States Securities and Exchange Commission will provide sufficient sources of liquidity to meet our operating needs for the foreseeable future.

### Critical Accounting Policies

We have made no changes in our methods of application of our critical accounting policies from the information provided in our Annual Report on Form 10-K for the year ended December 31, 2003.

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### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in market risk from the information provided in Item 7A. "Quantitative and Qualitative Disclosures About Market Risk" in our Annual Report on Form 10-K for the year ended December 31, 2003.

### ITEM 4. CONTROLS AND PROCEDURES

#### a. Evaluation of disclosure controls and procedures.

The term "disclosure controls and procedures" is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, or the Exchange Act. This term refers to the controls and procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission. Our management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report. Based upon the evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

#### b. Changes in internal controls.

There were no changes to our internal control over financial reporting during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

We are party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which we believe have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits, arbitrations and other proceedings which relate to disputes over contractual relationships with third parties, or which involve alleged errors and omissions on the part of our subsidiaries. A subsidiary has been named along with several other defendants in legal proceedings by certain of the insurance company members of a discontinued workers' compensation reinsurance facility commonly known as the Unicover Pool. During 1997 and 1998, our subsidiary was one of two co-intermediaries for the facility. Other defendants in the current proceedings include the other reinsurance intermediary, the former managing underwriter for the facility and various individuals, none of whom are affiliated with us. It is claimed in the proceedings that the actions of the various defendants resulted in the rescission of certain reinsurance contracts in an arbitration to which we were not a party and include allegations of breach of fiduciary duty, negligence, fraud and other allegations. The claims in the proceedings are for unspecified or substantial compensatory and punitive damages. We believe that we have meritorious defenses to the allegations and intend to vigorously defend against the claims made in the proceedings. In addition, we are presently

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engaged in litigation initiated by the appointed liquidator of a former reinsurer concerning payments made to us prior to the date of the appointment of the liquidator. The disputed payments were made by the now insolvent reinsurer in connection with a commutation agreement. Our understanding is that such litigation is one of a number of similar actions brought by the liquidator. We intend to vigorously contest the action. Although the ultimate outcome of these matters may not be determined at this time, based upon present information, the availability of insurance coverage and legal advice received, we do not believe the resolution of any of these matters, some of which include allegations of damages in material amounts, will have a material adverse effect on our financial condition, results of operations or cash flows.

### Item 6. Exhibits and Reports on Form 8-K

#### (a) Exhibits

31.1 Certification by Chief Executive Officer.

31.2 Certification by Chief Financial Officer.

32.1 Certification with respect to quarterly report.

#### (b) Reports on Form 8-K

On February 19, 2004, we furnished on Form 8-K our announcement of financial results for the fourth quarter and full year of 2003.

On February 23, 2004, we furnished on Form 8-K the text material used for presentations at various investor conferences.

On March 1, 2004, we furnished on Form 8-K the text materials used for presentations at various investor conferences.

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### SIGNATURES

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.

HCC Insurance Holdings, Inc.

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(Registrant)

May 6, 2004

/s/ Stephen L. Way

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(Date)

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Stephen L. Way, Chairman of the Board,  
Chief Executive Officer and President

May 6, 2004

/s/ Edward H. Ellis, Jr.

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(Date)

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Edward H. Ellis, Jr., Executive Vice President  
and Chief Financial Officer

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INDEX TO EXHIBITS

Exhibits

- 31.1 Certification by Chief Executive Officer.
- 31.2 Certification by Chief Financial Officer.
- 32.1 Certification with respect to quarterly report.