

Edgar Filing: MERCHANTS GROUP INC - Form 10-Q

MERCHANTS GROUP INC  
Form 10-Q  
May 14, 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 1-9640

-----  
MERCHANTS GROUP, INC.  
(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of incorporation or organization)

16-1280763  
(I.R.S. Employer Identification No.)

250 MAIN STREET, BUFFALO, NEW YORK  
(Address of principal executive offices)

14202  
(Zip Code)

716-849-3333  
(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, and (2) has been subject to such filing requirements for the past 90 days.

Yes [ x ] No [ ]

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). [ ]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of April 30, 2004: 2,114,152 SHARES OF COMMON STOCK.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED BALANCE SHEET

(in thousands)

|   | December 31,<br>2003 | March 31,<br>2004 |
|---|----------------------|-------------------|
|   | -----                | -----             |
|   | (unaudited)          |                   |
| Assets  |                      |                   |
| Investments:  |                      |                   |
| Fixed maturities:   |                      |                   |
| Available for sale at fair value (amortized cost<br>\$192,315 in 2003 and \$202,639 in 2004)      | 193,805              | 205,648           |
| Preferred stock at fair value   | 5,797                | 5,707             |
| Other long-term investments at fair value   | 2,167                | 2,167             |
| Short-term investments  | 1,118                | 2,994             |
|   | -----                | -----             |
| Total investments   | 202,887              | 216,516           |
| Cash  | 23                   | 4                 |
| Interest due and accrued  | 1,260                | 1,258             |
| Premiums receivable, net of allowance for doubtful<br>accounts of \$278 in 2003 and \$299 in 2004 | 16,677               | 14,766            |
| Deferred policy acquisition costs   | 8,623                | 7,332             |
| Reinsurance recoverable on paid and unpaid losses   | 22,715               | 20,291            |
| Prepaid reinsurance premiums  | 3,066                | 3,759             |
| Income taxes receivable   | 881                  | 614               |
| Deferred income taxes   | 4,497                | 3,976             |
| Other assets  | 11,637               | 11,975            |
|   | -----                | -----             |
| Total assets  | \$272,266            | \$280,491         |
|   | =====                | =====             |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED BALANCE SHEET

(in thousands except share amounts)

|                                      | December 31,<br>2003 | March 31,<br>2004 |
|--------------------------------------|----------------------|-------------------|
|                                      | -----                | -----             |
|                                      | (unaudited)          |                   |
| Liabilities and Stockholders' Equity |                      |                   |

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Liabilities:

|   |            |            |
|---|------------|------------|
| Reserve for losses and loss adjustment expenses | \$ 146,474 | \$ 141,312 |
| Unearned premiums                               | 36,176     | 31,930     |
| Payable to affiliate                            | 2,090      | 9,406      |
| Payable for securities                          | -          | 10,839     |
| Other liabilities                               | 17,267     | 15,132     |
|   | -----      | -----      |

|                   |         |         |
|-------------------|---------|---------|
| Total liabilities | 202,007 | 208,619 |
|                   | -----   | -----   |

Stockholders' equity:

|  |          |          |
|--|----------|----------|
| Common stock, 10,000,000 shares authorized, 2,110,152 shares issued and outstanding at December 31, 2003 and 2,114,152 shares issued and outstanding at March 31, 2004 | 32       | 33       |
| Additional paid in capital   | 35,795   | 35,878   |
| Treasury stock, 1,139,700 shares at December 31, 2003 and March 31, 2004   | (22,766) | (22,766) |
| Accumulated other comprehensive income   | 750      | 1,679    |
| Accumulated earnings   | 56,448   | 57,048   |
|  | -----    | -----    |

|                            |        |        |
|----------------------------|--------|--------|
| Total stockholders' equity | 70,259 | 71,872 |
|                            | -----  | -----  |

Commitments and contingent liabilities - -

|  |            |            |
|--|------------|------------|
| Total liabilities and stockholders' equity | \$ 272,266 | \$ 280,491 |
|  | =====      | =====      |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands except per share amounts)

|                               | Three Months<br>Ended March 31, |          |
|-------------------------------|---------------------------------|----------|
|                               | 2003                            | 2004     |
|                               | -----                           | -----    |
|                               | (unaudited)                     |          |
| Revenues:                     |                                 |          |
| Net premiums earned           | \$16,141                        | \$14,069 |
| Net investment income         | 2,331                           | 2,054    |
| Net realized investment gains | 116                             | 377      |
| Other revenues                | 33                              | 166      |
|                               | -----                           | -----    |
| Total revenues                | 18,621                          | 16,666   |
|                               | -----                           | -----    |

Expenses:

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|   |        |        |
|---|--------|--------|
| Net losses and loss adjustment expenses           | 12,917 | 10,089 |
| Amortization of deferred policy acquisition costs | 4,206  | 3,658  |
| Other underwriting expenses                       | 1,177  | 1,789  |
|   | -----  | -----  |
| Total expenses                                    | 18,300 | 15,536 |
|   | -----  | -----  |
| Income before income taxes                        | 321    | 1,130  |
| Income tax provision                              | 105    | 319    |
|   | -----  | -----  |
| Net income  | \$ 216 | \$ 811 |
|   | =====  | =====  |
| Basic and diluted earnings per share              | \$ .10 | \$ .38 |
|   | =====  | =====  |
| Weighted average shares outstanding:              |        |        |
| Basic   | 2,110  | 2,112  |
| Diluted   | 2,113  | 2,116  |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(in thousands)

|   | Three Months<br>Ended March 31, |          |
|---|---------------------------------|----------|
|   | 2003                            | 2004     |
|   | -----                           | -----    |
|   | (unaudited)                     |          |
| Net income  | \$ 216                          | \$ 811   |
|   | -----                           | -----    |
| Other comprehensive income (loss) before taxes:                                 |                                 |          |
| Unrealized gains (losses) on securities   | (751)                           | 1,784    |
| Reclassification adjustment<br>for gains included in net income                 | (116)                           | (377)    |
|   | -----                           | -----    |
| Other comprehensive income (loss) before taxes                                  | (867)                           | 1,407    |
| Income taxes (benefit) related to items<br>of other comprehensive income (loss) | (335)                           | 478      |
|   | -----                           | -----    |
| Other comprehensive income (loss)   | (532)                           | 929      |
|   | -----                           | -----    |
| Comprehensive income (loss)   | \$ (316)                        | \$ 1,740 |
|   | =====                           | =====    |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands)

|  | Three Months<br>Ended March 31, |           |
|--|---------------------------------|-----------|
|  | 2003                            | 2004      |
|  | -----<br>(unaudited)            |           |
| Common stock:                                  |                                 |           |
| Beginning of period                            | \$ 32                           | \$ 32     |
| Exercise of common stock options               | -                               | 1         |
|  | -----                           | -----     |
| End of period                                  | 32                              | 33        |
|  | -----                           | -----     |
| Additional paid in capital:                    |                                 |           |
| Beginning of period                            | 35,795                          | 35,795    |
| Exercise of common stock options               | -                               | 83        |
|  | -----                           | -----     |
| End of period                                  | 35,795                          | 35,878    |
|  | -----                           | -----     |
| Treasury stock beginning and end:              | (22,766)                        | (22,766)  |
|  | -----                           | -----     |
| Accumulated other comprehensive income (loss): |                                 |           |
| Beginning of period                            | 1,937                           | 750       |
| Other comprehensive income (loss)              | (532)                           | 929       |
|  | -----                           | -----     |
| End of period                                  | 1,405                           | 1,679     |
|  | -----                           | -----     |
| Accumulated earnings:                          |                                 |           |
| Beginning of period                            | 52,926                          | 56,448    |
| Net income                                     | 216                             | 811       |
| Cash dividends                                 | (210)                           | (211)     |
|  | -----                           | -----     |
| End of period                                  | 52,932                          | 57,048    |
|  | -----                           | -----     |
| Total stockholders' equity                     | \$ 67,398                       | \$ 71,872 |
|  | =====                           | =====     |

See Notes to the Consolidated Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

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(in thousands)

|   | Three Months<br>Ended March 31, |           |
|---|---------------------------------|-----------|
|   | 2003                            | 2004      |
|   | -----<br>(unaudited)            |           |
| Cash flows from operations:                       |                                 |           |
| Collection of premiums                            | \$ 12,852                       | \$ 11,222 |
| Payment of losses and loss adjustment expenses    | (14,162)                        | (14,256)  |
| Payment of other underwriting expenses            | (6,959)                         | (6,274)   |
| Investment income received                        | 2,372                           | 2,115     |
| Investment expenses paid                          | (74)                            | (73)      |
| Income taxes paid                                 | (145)                           | (10)      |
| Other   | 33                              | 166       |
|   | -----                           | -----     |
| Net cash used in operations                       | (6,083)                         | (7,110)   |
|   | -----                           | -----     |
| Cash flows from investing activities:             |                                 |           |
| Proceeds from fixed maturities sold or matured    | 34,066                          | 8,330     |
| Purchase of fixed maturities                      | (30,903)                        | (18,284)  |
| Net decrease in preferred stock                   | 1,500                           | -         |
| Net increase in other long-term investments       | (30)                            | -         |
| Net (increase) decrease in short-term investments | 1,420                           | (1,876)   |
| Increase in payable for securities                | -                               | 10,839    |
| Decrease in receivable for securities             | -                               | 893       |
|   | -----                           | -----     |
| Net cash provided by investing activities         | 6,053                           | (98)      |
|   | -----                           | -----     |
| Cash flows from financing activities:             |                                 |           |
| Settlement of affiliate balances                  | 237                             | 7,316     |
| Exercise of common stock options                  | -                               | 84        |
| Cash dividends                                    | (210)                           | (211)     |
|   | -----                           | -----     |
| Net cash provided by financing activities         | 27                              | 7,189     |
|   | -----                           | -----     |
| Decrease in cash                                  | (3)                             | (19)      |
| Cash:   |                                 |           |
| Beginning of period                               | 9                               | 23        |
|   | -----                           | -----     |
| End of period                                     | \$ 6                            | \$ 4      |
|   | =====                           | =====     |

See Notes to the Consolidated Financial Statements

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## RECONCILIATION OF NET INCOME TO NET CASH

### USED IN OPERATIONS

(in thousands)

|   | Three Months<br>Ended March 31, |            |
|---|---------------------------------|------------|
|   | 2003                            | 2004       |
|   | -----                           | -----      |
|   | (unaudited)                     |            |
| Net income                                      | \$ 216                          | \$ 811     |
| Adjustments:                                    |                                 |            |
| Amortization (accretion), net                   | 12                              | (14)       |
| Realized investment gains                       | (116)                           | (377)      |
| (Increase) decrease in assets:                  |                                 |            |
| Interest due and accrued                        | (45)                            | 2          |
| Premiums receivable                             | (1,997)                         | 1,911      |
| Deferred policy acquisition costs               | 284                             | 1,291      |
| Ceded reinsurance balances receivable           | 4                               | 2,424      |
| Prepaid reinsurance premiums                    | 171                             | (693)      |
| Income taxes receivable                         | -                               | 267        |
| Deferred income taxes                           | 24                              | 42         |
| Other assets                                    | (252)                           | (1,231)    |
| Increase (decrease) in liabilities:             |                                 |            |
| Reserve for losses and loss adjustment expenses | (1,156)                         | (5,162)    |
| Unearned premiums                               | (1,465)                         | (4,246)    |
| Other liabilities                               | (1,763)                         | (2,135)    |
|   | -----                           | -----      |
| Net cash used in operations                     | \$ (6,083)                      | \$ (7,110) |
|   | =====                           | =====      |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. Principles of Consolidation and Basis of Presentation

The consolidated balance sheet as of March 31, 2004 and the related consolidated statements of operations, of comprehensive income, of changes in stockholders' equity and of cash flows for the three months ended March 31, 2003 and 2004, respectively, are unaudited. In the opinion of management, the interim financial statements reflect all adjustments necessary for a fair presentation of financial position and results of operations. Such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results for a full year.

The consolidated financial statements include the accounts of Merchants Group, Inc. (the Company), its wholly-owned subsidiary, Merchants Insurance Company of

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New Hampshire, Inc. (MNH), and M.F.C. of New York, Inc., an inactive premium finance company which is a wholly-owned subsidiary of MNH. The accompanying consolidated financial statements should be read in conjunction with the following notes and the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which differ in some respects from those followed in reports to insurance regulatory authorities. All significant intercompany balances and transactions have been eliminated.

### 2. Related Party Transactions

With the exception of the individual who serves as both the President of the Company and the Chief Operating Officer of MNH, the Company and MNH have no paid employees. Under a management agreement dated September 26, 1986 (the Management Agreement), Merchants Mutual Insurance Company (Mutual), which owned 12.1% of the Company's common stock at March 31, 2004, provided the Company and MNH with the facilities, management and personnel required to manage their day-to-day business through December 31, 2002. All underwriting, administrative, claims and investment expenses incurred on behalf of Mutual and MNH were shared on an allocated cost basis. Effective January 1, 2003, the Company, MNH and Mutual entered into a new agreement (the Services Agreement) for Mutual to provide underwriting, administrative, claims and investment services to the Company and MNH and to manage the traditional property and casualty insurance business of MNH on substantially the same terms as under the Management Agreement. As of January 1, 2003 MNH and Mutual entered into a reinsurance pooling agreement (the Reinsurance Pooling Agreement) that provides for the pooling, or sharing, of the insurance business traditionally written by Mutual and MNH. The Reinsurance Pooling Agreement applies to premiums earned and losses incurred on or after its effective date. The terms of these agreements are more fully described in the Company's Annual Report of Form 10-K for the year ended December 31, 2003.

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### 3. Earnings Per Share

Basic and diluted earnings per share were computed by dividing net income by the weighted average number of shares of common stock outstanding during each period. For diluted earnings per share, the weighted average number of shares outstanding was increased by the assumed exercise of options for 31,500 and 35,500 shares of common stock in the three month periods ending March 31, 2004 and 2003, respectively, which would have resulted in 4,859 and 2,745 additional shares outstanding for the three month periods ending March 31, 2004 and 2003, respectively, assuming the proceeds to the Company from exercise were used to purchase shares of the Company's common stock at its average market value per share during the quarter.

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

Results of Operations for the Three Months Ended March 31, 2004 As Compared to the Three Months Ended March 31, 2003

The following discussion should be considered in light of the statements under the heading "Safe Harbor Statement under the Securities Litigation Reform Act of



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1995," at the end of this Item. All capitalized terms used in this Item that are not defined in this Item have the meanings given to them in Notes to Consolidated Financial Statements contained in Item 1 of this Form 10-Q, which is incorporated herein by reference.

Total revenues for the three months ended March 31, 2004 were \$16,666,000, a decrease of \$1,955,000 or 10% from \$18,621,000 for the three months ended March 31, 2003.

Results of operations for the three months ended March 31, 2004 and 2003 reflect the effects of the Services Agreement and the Reinsurance Pooling Agreement among the Company and its wholly-owned insurance subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH) and Merchants Mutual Insurance Company (Mutual), effective January 1, 2003. The Services Agreement calls for Mutual to provide underwriting, administrative, claims and investment services to the Company and MNH. The Reinsurance Pooling Agreement provides for the pooling, or sharing, of insurance business traditionally written by Mutual and MNH on or after the effective date. MNH's share of pooled (combined Mutual and MNH) premiums earned and losses and loss adjustment expenses (LAE) for 2004 in accordance with the Reinsurance Pooling Agreement is 35%. MMH's share of pooled premiums earned and losses and LAE was 40% in 2003. The Reinsurance Pooling Agreement pertains to premiums earned and incurred losses and LAE. Direct premiums written by MNH and Mutual are not pooled.

Total combined Mutual and MNH or "group-wide" direct premiums written (DWP) for the three months ended March 31, 2004 were \$45,103,000, an increase of \$4,349,000 or 11% from \$40,754,000 in 2003. The Company's pro-forma share of combined direct premiums written in 2004, in accordance with the Reinsurance Pooling Agreement, was \$15,786,000 compared to \$16,302,000 in 2003. The table below shows a comparison of direct premiums written by major category in 2004 and 2003:

|                               | Group-wide DWP     |          |          | MNH Pro- |
|-------------------------------|--------------------|----------|----------|----------|
|                               | Three months ended |          |          | Three mo |
|                               | March 31,          |          |          | Ma       |
|                               | 2004               | 2003     | Variance | 2004     |
|                               | ----               | ----     | -----    | ----     |
|                               | (000's omitted)    |          |          | (000     |
| Voluntary Personal Lines      | \$12,556           | \$15,212 | (17%)    | \$ 4,395 |
| Voluntary Commercial Lines    | 31,662             | 23,682   | 34%      | 11,082   |
| Involuntary                   | 885                | 1,860    | (52%)    | 309      |
|                               | -----              | -----    |          | -----    |
| Total Direct Written Premiums | \$45,103           | \$40,754 | 11%      | \$15,786 |
|                               | =====              | =====    |          | =====    |

The 17% decrease in group-wide voluntary personal lines direct premiums written resulted from a 21% decrease in private passenger automobile (PPA) direct premiums written and a 5% decrease in homeowners direct premiums written. The decrease in PPA direct premiums written is the result of the companies' policy, implemented in 2002, not to write new policies in certain jurisdictions and of the approval of the

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companies' plan to withdraw from the New Jersey PPA market by the New Jersey Department of Banking and Insurance which was effective in June 2003. As a result, voluntary PPA policies in force at March 31, 2004 were 26,438, a decrease of 7,159, or 21%, from 33,597 at March 31, 2003.

Group-wide voluntary commercial lines direct premiums written increased \$7,980,000 or 34% to \$31,662,000 for the three months ended March 31, 2004, from \$23,682,000 for the three months ended March 31, 2003. Approximately 60% of this increase (\$4,800,000) resulted from a monoline commercial umbrella program introduced by Mutual in the fourth quarter of 2003 (the Umbrella Program). The Umbrella Program is marketed exclusively through one independent agent and approximately 95% of the premiums related to these policies are reinsured with an "A+" rated national reinsurer through a quota share reinsurance treaty. There were no similar direct premiums written in the three months ended March 31, 2003 as the program was initiated during the fourth quarter of 2003.

The remainder of the increase in commercial lines direct premiums written resulted from period to period increases in every group-wide commercial line of business. The average premium per group-wide, non-Umbrella Program commercial lines policy increased 9% from the year earlier period while total non-Umbrella Program commercial lines policies in force at March 31, 2004 were 31,309, substantially unchanged from 31,322 at March 31, 2003.

The 52% decrease in group-wide involuntary written premiums, which consist primarily of involuntary PPA insurance, resulted primarily from a decrease in group-wide assignments from the New York Automobile Insurance Plan (NYAIP). NYAIP assignments decreased to \$623,000 for the three months ended March 31, 2004 compared to \$1,389,000 for the three months ended March 31, 2003. The NYAIP provides coverage for individuals who are unable to obtain auto insurance in the voluntary market. Assignments from the NYAIP vary depending upon a company's PPA market share and the size of the NYAIP. The Company is unable to predict the volume of future assignments from the NYAIP.

In order to minimize the adverse impact of assignments from the NYAIP, the Company purchased territorial credits from an unaffiliated insurance company pursuant to Section 6.A.7. of the NYAIP Manual. The credits against NYAIP assignments were generated by the other insurance company for writing PPA business in certain localities in New York with PPA market availability problems. The other insurance company, by nature of its concentration in PPA business in "credit" territories, generated more credits than it required to offset its NYAIP assignments. The credits purchased reduced the Company's share of the NYAIP. The company believes that the costs of the credits purchased, which are pooled in accordance with the Reinsurance Pooling Agreement, were substantially less than the amount the Company would have lost had it written the additional NYAIP business.

Group-wide total direct premiums written excluding the Umbrella Program decreased 1% as compared to the year earlier period.

Group-wide pooled net premiums written for 2004 were \$37,910,000, a decrease of \$448,000, or 1% from \$38,358,000 for the three months ended March 31, 2003. This decrease resulted from the 1% decrease in non-Umbrella Program group-wide direct premiums written. The Company's share of 2004 pooled net premiums written was \$9,130,000, a decrease of \$5,717,000, or 39%, from \$14,847,000 in 2003.

The Company's share of pooled net premiums earned in accordance with the Reinsurance Pooling Agreement for the three months ended March 31, 2004 was \$14,069,000, compared to \$16,141,000 for the three months ended March 31, 2003.

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This \$2,072,000, or 13%, decrease in net premiums earned resulted primarily from the 5 percentage point decrease in the Company's participation in the Reinsurance Pooling Agreement.

Net investment income was \$2,054,000 for the three months ended March 31, 2004, a decrease of 12% from \$2,331,000 for the three months ended March 31, 2003. The average pre-tax yield on the investment portfolio decreased 39 basis points to 4.3% for the three months ended March 31, 2004 from the three months ended March 31, 2003. Average invested assets for the three months ended March 31, 2004 were substantially unchanged from the year earlier period.

Net losses and LAE were \$10,089,000 for the three months ended March 31, 2004, a decrease of \$2,828,000, or 22%, from \$12,917,000 for the three months ended March 31, 2003. The loss and LAE ratio decreased to 71.7% for the three months ended March 31, 2004 from 80.0% for the three months ended March 31, 2003. Approximately 7.3 percentage points of the decrease in the loss and LAE ratio relates to an improvement in the loss and LAE ratio for the 2004 accident year (losses occurring in the first quarter of 2004) compared to the 2003 accident year (losses occurring in the first quarter of 2003).

The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned increased to 38.7% for the three months ended March 31, 2004 from 33.3% for the three months ended March 31, 2003. During 2004 the Company recorded as other underwriting expenses \$116,000 of amortization of NYAIP territorial credits (described above), compared to \$7,000 in 2003. Other underwriting expenses also included \$344,000 (2.4 percentage points of the expense ratio) of retrospective commissions related to the Reinsurance Pooling Agreement. The commissions are owed to Mutual based on a decrease during the first quarter of 2004 in the estimated cumulative loss and LAE ratio since the inception of the Reinsurance Pooling Agreement, and primarily represent the reversal of contingent commissions earned by MNH from Mutual during 2003. There were no similar amounts either positive or negative, recorded in the first quarter of 2003. Other underwriting expenses for 2004 also reflect the effect of a May 2003 change in New York law, which increased the premium tax rate from 1.3% to 2.0%. The impact of this change on 2004 was approximately \$68,000 and added .5 percentage points to the Company's expense ratio. Commissions, premium taxes and other state assessments that vary directly with the Company's premium volume represented 18.7% of net premiums earned in the three months ended March 31, 2004 compared to 20.9% in the three months ended March 31, 2003.

The Company's effective income tax rates for the three months ended March 31, 2004 and 2003 were 28.2% and 32.7%, respectively. These rates were calculated based upon the Company's estimates of the effective income tax rate for each full year. The decrease in the effective income tax rate was primarily due to an increase in tax exempt income as a percentage of pre-tax income.

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### Liquidity and Capital Resources

Historically, when developing its investment strategy the Company determines a level of cash and short-term investments which, when combined with expected cash flow, is estimated to be adequate to meet expected cash obligations. Due to declining written premiums however, the Company's operating activities have resulted in a use of cash each year since 2001. The Company's decreasing participation percentage in the pooled business over the remaining years of the Reinsurance Pooling Agreement will likely result in future negative cash flows from operations. The Company believes that careful management of the relationship between assets and liabilities will minimize the likelihood that investment portfolio sales will be necessary to fund insurance operations, and

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that the effect of any such sale on the Company's stockholders' equity will not be material.

The Company's objectives with respect to its investment portfolio include maximizing total return within investment guidelines while protecting policyholders' surplus and maintaining flexibility. Like other property and casualty insurers, the Company relies on premiums as a major source of cash, and therefore liquidity. Cash flows from the Company's investment portfolio, either in the form of interest or principal payments, are an additional source of liquidity. Because the duration of the Company's investment portfolio is shorter than the duration of its liabilities, increases or decreases in market interest rates are not expected to have a material effect on the Company's liquidity or its results of operations.

The Company designates newly acquired fixed maturity investments as available for sale and carries these investments at fair value. Unrealized gains and losses related to these investments are recorded as accumulated other comprehensive income within stockholders' equity. At March 31, 2004, the Company recorded as accumulated other comprehensive income in its Consolidated Balance Sheet \$1,679,000 of unrealized gains, net of taxes, associated with its investments classified as available for sale.

At March 31, 2004, the Company's portfolio of fixed maturity investments represented 95.0% of invested assets. Management believes that this level of fixed maturity investments is consistent with the Company's liquidity needs because it anticipates that cash receipts from net premiums written and investment income will enable the Company to satisfy its cash obligations. Furthermore, a portion of the Company's fixed maturity investments are invested in mortgage-backed and other asset-backed securities which, in addition to interest income, provide monthly paydowns of bond principal.

At March 31, 2004 \$126,576,000, or 61.6%, of the Company's fixed maturity portfolio was invested in mortgage-backed and other asset-backed securities. The Company invests in a variety of collateralized mortgage obligation ("CMO") products but has not invested in the derivative type of CMO products such as interest only, principal only or inverse floating rate securities. All of the Company's CMO investments have a secondary market and their effect on the Company's liquidity does not differ from that of other fixed maturity investments.

At March 31, 2004 \$1,486,000, or .7%, of the Company's investment portfolio was invested in non-investment grade securities compared to \$3,992,000, or 2.0%, at March 31, 2003.

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The Company has arranged for a \$2,000,000 unsecured credit facility from a bank. Any borrowings under this facility are payable on demand and carry an interest rate which can be fixed or variable and is negotiated at the time of each advance. This facility is available for general working capital purposes and for repurchases of the Company's common stock. At March 31, 2004 no amount was outstanding on this loan.

As a holding company, the Company is dependent on cash dividends from MNH to meet its obligations and to pay any cash dividends. MNH is subject to New Hampshire insurance laws which place certain restrictions on its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of the insurer's statutory policyholders' surplus as of the preceding December 31st. The maximum

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amount of dividends that MNH could pay during any twelve month period ending in 2004 without the prior approval of the New Hampshire Insurance Commissioner is \$5,767,000. MNH paid \$1,200,000 of dividends to the Company in 2003. Dividend payments of \$600,000 were made in April 2003 and November 2003. The Company paid cash dividends to its common stockholders of \$.10 per share in the first quarter of 2004 amounting to \$211,000. On May 5, 2004 the Company declared a quarterly cash dividend of \$.10 per share payable on June 4, 2004 to shareholders of record as of the close of business on May 19, 2004.

Under the Management Agreement and the Services Agreement, Mutual has provided services and facilities for MNH to conduct its insurance business on a cost reimbursed basis. The balance in the payable to or receivable from affiliate account represents the amount owing to or owed by Mutual by or to the Company for the difference between premiums collected and payments made for losses, employees, services and facilities by Mutual on behalf of MNH.

Regulatory guidelines suggest that the ratio of a property-casualty insurer's annual net premiums written to its statutory surplus should not exceed 3 to 1. MNH has consistently followed a business strategy that would allow it to meet this 3 to 1 regulatory guideline. For the first three months of 2004, MNH's ratio of net premiums written to statutory surplus, annualized for a full year, was .6 to 1.

### Relationship with Mutual

The Company's and MNH's business and day-to-day operations are closely aligned with those of Mutual. This is the result of a combination of factors. Mutual has had a historical ownership interest in the Company and MNH. Prior to November 1986 MNH was a wholly-owned subsidiary of Mutual. Following the Company's initial public offering in November 1986 and until a secondary stock offering in July 1993 the Company was a majority-owned subsidiary of Mutual. Mutual currently owns 12.1% of the Company's common stock. Under the Services Agreement, Mutual provides the Company and MNH with all facilities and personnel to operate their business. With the exception of the individual who serves as President of the Company and the Chief Operating Officer of MNH, the only other officers of the Company or MNH are employees of Mutual whose services are provided to, and paid for by, the Company and MNH through the Services Agreement. Also, the operation of MNH's insurance business, which offers substantially the same lines of insurance as Mutual through the same independent insurance agents, creates a very close relationship among the Companies.

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"Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995:

With the exception of historical information, the matters and statements discussed, made or incorporated by reference in this Quarterly Report on Form 10-Q constitute forward-looking statements and are discussed, made or incorporated by reference, as the case may be, pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, statements relating to the Company's plans, strategies, objectives, expectations and intentions. Words such as "believes," "forecasts," "intends," "possible," "expects," "anticipates," "estimates," or "plans" and similar expressions are intended to identify forward looking statements. Such forward-looking statements involve certain assumptions, risks and uncertainties that include, but are not limited to, those associated with factors affecting the property-casualty insurance industry generally, including price competition, the Company's dependence on state insurance departments for approval of rate increases; size and frequency

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of claims, escalating damage awards, natural disasters, fluctuations in interest rates and general business conditions; the Company's dependence on investment income; the geographic concentration of the Company's business in the northeastern United States and in particular in New York, New Hampshire, New Jersey, Rhode Island, Pennsylvania and Massachusetts; the adequacy of the Company's loss reserves; the Company's dependence on the general reinsurance market; government regulation of the insurance industry; exposure to environmental claims; dependence of the Company on its relationship with Mutual; and the other risks and uncertainties discussed or indicated in all documents filed by the Company with the Securities and Exchange Commission. The Company expressly disclaims any obligation to update any forward-looking statements as a result of developments occurring after the filing of this report.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

#### Market Risk

Market risk represents the potential for loss due to changes in the fair value of financial instruments. The market risk related to the Company's financial instruments primarily relates to its investment portfolio. The value of the Company's investment portfolio of \$216,516,000 at March 31, 2004 is subject to changes in interest rates and to a lesser extent on credit quality. Further, certain mortgage-backed and asset-backed securities are exposed to accelerated prepayment risk generally caused by interest rate movements. If interest rates were to decline, mortgage holders would be more likely to refinance existing mortgages at lower rates. Acceleration of future repayments could adversely affect future investment income, if reinvestment of the accelerated receipts was made in lower yielding securities.

The following table provides information related to the Company's fixed maturity investments at March 31, 2004. The table presents cash flows of principal amounts and related weighted average interest rates by expected maturity dates. The cash flows are based upon the maturity date or, in the case of mortgage-backed and asset-backed securities, expected payment patterns. Actual cash flows could differ from those shown in the table.

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#### Fixed Maturities

Expected Cash Flows of Principal Amounts (\$ in 000's):

|   | 2004  | 2005     | 2006  | 2007  | 2008     |
|---|-------|----------|-------|-------|----------|
|   | ----  | ----     | ----  | ----  | ----     |
| Available for Sale  |       |          |       |       |          |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies |       |          |       |       |          |
| Average interest rate   | \$ 0  | \$ 5,142 | \$ 0  | \$ 0  | \$ 3,007 |
| Average interest rate   | 0.0%  | 3.9%     | 0.0%  | 0.0%  | 3.2%     |
| Obligations of states and political subdivisions                                      |       |          |       |       |          |
|   | 1,399 | 8,494    | 9,632 | 3,889 | 15,151   |

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|                       |           |           |           |           |           |
|-----------------------|-----------|-----------|-----------|-----------|-----------|
| Average interest rate | 4.1%      | 3.2%      | 3.4%      | 4.3%      | 3.9%      |
| Corporate securities  | 2,169     | 18,631    | 0         | 0         | 3,237     |
| Average interest rate | 5.4%      | 4.3%      | 0.0%      | 0.0%      | 3.7%      |
| Mortgage & asset      |           |           |           |           |           |
| backed securities     | 22,628    | 29,285    | 25,673    | 16,140    | 2,869     |
| Average interest rate | 5.1%      | 5.1%      | 5.1%      | 5.1%      | 5.2%      |
|                       | -----     | -----     | -----     | -----     | -----     |
| Total                 | \$ 26,196 | \$ 61,552 | \$ 35,305 | \$ 20,029 | \$ 24,264 |
|                       | =====     | =====     | =====     | =====     | =====     |

The discussion and the estimated amounts referred to above include forward-looking statements of market risk which involve certain assumptions as to market interest rates and the credit quality of the fixed maturity investments. Actual future market conditions may differ materially from such assumptions. Accordingly, the forward-looking statements should not be considered projections of future events by the Company.

### Item 4. Controls and Procedures

The Company's chief executive officer and chief financial officer, after evaluating the effectiveness of the Company's "disclosure controls and procedures" (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934) as of the end of the period covered by this report, concluded that the Company's disclosure controls and procedures were effective to ensure that material information relating to the Company was being made known to them by others within the Company in a timely manner, including the period when this quarterly report was being prepared.

There was no change in the Company's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rules 13a-15 or 15d-15 under the Securities Exchange Act of 1934 that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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## PART II. OTHER INFORMATION

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 of Security Holders  
None.

Item 5. Other Information.  
None.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits.  
Exhibits required by Item 601 of Regulation S-K.

3(a) Restated Certificate of Incorporation (incorporated by

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reference to Exhibit No. 3C to Amendment No. 1 to the Company's Registration Statement No. 33-9188 on Form S-1 Filed on November 7, 1986.

- (b) Restated By-laws (incorporated by reference to Exhibit 3D to Amendment No. 1 to the Company's Registration Statement No. 33-9188 on Form S-1 filed on November 7, 1986.
- 4 Instruments defining the rights of security holders, including indentures - N/A.
- 5 Opinion re legality - N/A.
- 10(a) Management Agreement dated as of September 29, 1986 by and among Merchants Mutual Insurance Company, Registrant and Merchants Insurance Company of New Hampshire, Inc. (incorporated by reference to Exhibit No. 10a to the Company's Registration Statement (No. 33-9188) on Form S-1 filed on September 30, 1986).
- (b) Services Agreement Among Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and Merchants Group, Inc. dated January 1, 2003 (incorporated by reference to Exhibit No. 10b to the Company's 2003 Quarterly Report on Form 10-Q filed on May 14, 2003).

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- (c) Reinsurance Pooling Agreement between Merchants Insurance Company of New Hampshire, Inc. and Merchants Mutual Insurance Company effective January 1, 2003 (incorporated by reference to Exhibit No. 10c to the Company's 2003 Quarterly Report on Form 10-Q filed on May 14, 2003).
- (d) Casualty Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company (incorporated by reference to Exhibit 10(f) to the Company's 2002 Annual Report on Form 10-K filed on March 31, 2002).
- (e) Endorsement to the Casualty Excess of Loss Reinsurance agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company dated September 29, 2003 (incorporated by reference to Exhibit 10 (f) to the Company's 2003 Quarterly Report on Form 10-Q filed on November 13, 2003).
- (f) Property Per Risk Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company (incorporated by reference to Exhibit 10(g) to the Company's 2002 Annual Report on Form 10-K filed on March 31, 2002).
- (g) Endorsement to the Property Per Risk Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company dated September 24, 2003



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(incorporated by reference to Exhibit 10(h) to the Company's 2003 Quarterly Report on Form 10-Q filed on November 13, 2003).

- (h) Property Catastrophe Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and the various reinsurers as identified by the Interest and Liabilities Agreements attaching to and forming part of this Agreement (incorporated by reference to Exhibit 10(g) to the Company's 2003 Quarterly Report on Form 10-Q filed on November 13, 2003).
- (i) Quota Share Reinsurance Treaty Agreement between Merchants Insurance Company of New Hampshire, Inc. and The Subscribing Underwriting Members of Lloyd's, London specifically identified on the schedules attached to this agreement dated January 1, 2000 (incorporated by reference to Exhibit 10h to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
- (j) Merchants Mutual Capital Accumulation Plan (incorporated by reference to Exhibit No. 10g to the Company's Registration Statement (No. 33-9188) on Form S-1 filed on September 30, 1986).

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- (k) Merchants Mutual Capital Accumulation Plan, fifth amendment, effective January 1, 1999 (incorporated by reference to Exhibit 10j to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
- \* (l) Form of Amended Indemnification Agreement entered into by Registrant with each director and executive officer of Registrant (incorporated by reference to Exhibit No. 10n to Amendment No. 1 to the Company's Registration Statement on (No. 33-9188) Form S-1 filed on November 7, 1986).
- \* (m) Merchants Mutual Insurance Company Adjusted Return on Equity Incentive Compensation Plan January 1, 2000 (incorporated by reference to Exhibit 10p to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
- \* (n) Merchants Mutual Insurance Company Adjusted Return on Equity Long Term Incentive Compensation Plan January 1, 2000 (incorporated by reference to Exhibit 10q to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
- \* (o) Amendment No. 1 to Employee Retention Agreement between Robert M. Zak and Merchants Mutual Insurance Company originally dated as of May 1, 1999, dated February 6, 2002 (incorporated by reference to Exhibit 10(s) to the Company's 2002 Annual Report on Form 10-K filed on March 31, 2003).
- \* (p) Amendment No. 1 to Employee Retention Agreement between Edward M. Murphy and Merchants Mutual Insurance Company originally dated as of March 1, 1999, dated February 6, 2002 (incorporated by reference to Exhibit 10(t) to the Company's 2002 Annual Report on Form 10-K filed on March 31, 2003).

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- \* (q) Amendment No. 1 to Employee Retention Agreement between Kenneth J. Wilson and Merchants Mutual Insurance Company originally dated as of March 1, 1999, dated February 6, 2002 incorporated by reference to Exhibit 10(u) to the Company's 2002 Annual Report on Form 10-K filed on March 31, 2003.
- \* (r) Employment Agreement between Stephen C. June and Merchants Insurance Company of New Hampshire, Inc. dated as of April 1, 2002 (incorporated by reference to Exhibit 10u to the Company's 2001 Annual Report on Form 10-K filed on March 27, 2002).
- 11 Statement re computation of per share earnings - N/A.
- 12 Statement re computation of ratios - N/A.
- 15 Letter re unaudited interim financial information - N/A.
- 18 Letter re change in accounting principles - N/A.

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- 19 Report furnished to security holder - N/A.
- 22 Published report regarding matters submitted to vote of security holders - N/A.
- 23 Consents of experts and counsel - N/A.
- 24 Power of attorney - N/A.
- 31 Rule 13a-14(a)/15d-14(a) Certifications (filed herewith)
- 32(a) Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) (filed herewith).

\* Indicates a management contract or compensation plan or arrangement.

(b) Reports on Form 8-K.

On April 30, 2004, the Company filed a Form 8-K reporting the issuance of a press release announcing results for the quarter ended March 31, 2004.

On May 6, 2004, the Company filed a Form 8-K reporting the issuance of a press release announcing the declaration of the Company's regular quarterly common stock dividend.

### 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.

MERCHANTS GROUP, INC.  
(Registrant)

Date: May 14, 2004

By: /s/ Kenneth J. Wilson

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Kenneth J. Wilson  
Chief Financial Officer and

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Treasurer (duly authorized  
officer of the registrant and  
chief accounting officer)

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