VEECO INSTRUMENTS INC
Form 10-Q
November 08, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from to .

Commission file number 0-16244

VEECO INSTRUMENTS INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**11-2989601**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)
Terminal Drive **Plainview, New York**	**11803**
(Address of Principal Executive Offices)	(Zip Code)

Registrant s telephone number, including area code: **(516) 677-0200**

Website: **www.veeco.com**

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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a Smaller reporting company)	Smaller reporting company o

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

39,245,212 shares of common stock were outstanding as of the close of business on November 1, 2013.

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Safe Harbor Statement

This quarterly report on Form 10-Q (the Report) contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Discussions containing such forward-looking statements may be found in Part I. Items 2 and 3 hereof, as well as within this Report generally. In addition, when used in this Report, the words believes, anticipates, expects, estimates, plans, intends will and similar expressions are intended to identify forward-looking statement forward-looking statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from projected results. These risks and uncertainties include, without limitation, the following:

- Our operating results have been, and may continue to be, adversely affected by unfavorable market conditions;
- Timing of market adoption of light emitting diode (LED) technology for general lighting is uncertain;
- Our failure to successfully manage our outsourcing activities or failure of our outsourcing partners to perform as anticipated could adversely affect our results of operations and our ability to adapt to fluctuating order volumes;
- The further reduction or elimination of foreign government subsidies and economic incentives may adversely affect the future order rate for our metal organic chemical vapor deposition (MOCVD) equipment;
- Our operating results have been, and may continue to be, adversely affected by tightening credit markets;
- Our backlog is subject to customer cancellation or modification and such cancellation could result in decreased sales and increased provisions for excess and obsolete inventory and/or liabilities to our suppliers for products no longer needed;
- Our failure to estimate customer demand accurately could result in excess or obsolete inventory and/or liabilities to our suppliers for products no longer needed, while manufacturing interruptions or delays could affect our ability to meet customer demand;
- The cyclicality of the industries we serve directly affects our business;
- We rely on a limited number of suppliers, some of whom are our sole source for particular components;
- Our sales to LED and data storage manufacturers are highly dependent on these manufacturers sales for consumer electronics applications, which can experience significant volatility due to seasonal and other factors, which could materially adversely impact our future results of operations;
- We are exposed to the risks of operating a global business, including the need to obtain export licenses for certain of our shipments and political risks in the countries we operate;
- We may be exposed to liabilities under the Foreign Corrupt Practices Act and any determination that we violated these or similar laws could have a material adverse effect on our business;
- The timing of our orders, shipments, and revenue recognition may cause our quarterly operating results to fluctuate significantly;
- We operate in industries characterized by rapid technological change;

- We face significant competition;

- We depend on a limited number of customers, located primarily in a limited number of regions, that operate in highly concentrated industries;

- Our sales cycle is long and unpredictable;

- Our material weaknesses in our internal controls which have impeded, and may continue to impede, our ability to file timely and accurate periodic reports may cause us to incur significant additional costs and may continue to affect our stock price;

- The price of our common shares may be volatile and could decline significantly;

- Our inability to attract, retain, and motivate key employees could have a material adverse effect on our business;

- We are subject to foreign currency exchange risks;

- The enforcement and protection of our intellectual property rights may be expensive and could divert our limited resources;

- We may be subject to claims of intellectual property infringement by others;

- If we are subject to cyber-attacks we could incur substantial costs and, if such attacks are successful, could result in significant liabilities, reputational harm and disruption of our operations;

- Our acquisition strategy subjects us to risks associated with evaluating and pursuing these opportunities and integrating these businesses;

- We may be required to take additional impairment charges for goodwill and indefinite-lived intangible assets or definite-lived intangible and long-lived assets;

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- Changes in accounting pronouncements or taxation rules or practices may adversely affect our financial results;
- We are subject to internal control evaluations and attestation requirements of Section 404 of the Sarbanes-Oxley Act and any delays or difficulty in satisfying these requirements or negative reports concerning our internal controls could adversely affect our future results of operations and our stock price;
- We are subject to risks of non-compliance with environmental, health and safety regulations;
- We have significant operations in locations which could be materially and adversely impacted in the event of a natural disaster or other significant disruption;
- We have adopted certain measures that may have anti-takeover effects which may make an acquisition of our Company by another company more difficult;
- New regulations related to conflict minerals will force us to incur additional expenses, may make our supply chain more complex, and may result in damage to our relationships with customers; and
- The matters set forth in this Report generally, including the risk factors set forth in Part II. Item 1A. Risk Factors.

Consequently, such forward looking statements should be regarded solely as the current plans, estimates and beliefs of Veeco Instruments Inc. (together with its consolidated subsidiaries, Veeco , the Company , we , us , and our , unless the context indicates otherwise). The Company do not undertake any obligation to update any forward looking statements to reflect future events or circumstances after the date of such statements.

Available Information

We file annual, quarterly and current reports, information statements and other information with the SEC. The public may obtain information by calling the SEC at 1-800-SEC-0330. The SEC also maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The address of that site is *www.sec.gov*.

Internet Address

We maintain a website where additional information concerning our business and various upcoming events can be found. The address of our website is *www.veeco.com.* We provide a link on our website, under Investors Financial Information SEC Filings, through which investors can access our filings with the SEC, including our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to such reports. These filings are posted to our website as soon as reasonably practicable after we electronically file such material with the SEC.

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VEECO INSTRUMENTS INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Veeco Instruments Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
(In thousands, except per share data)
(Unaudited)

	For the three months ended September 30, 2013	For the three months ended September 30, 2012	For the nine months ended September 30, 2013	For the nine months ended September 30, 2012
Net sales	$ 99,324	$ 132,715	$ 258,540	$ 409,171
Cost of sales	69,016	82,831	171,040	232,765
Gross profit	30,308	49,884	87,500	176,406
Operating expenses (income):				
Selling, general and administrative	19,650	13,892	59,077	54,558
Research and development	18,993	25,775	60,600	72,991
Amortization	855	1,477	2,566	3,877
Restructuring	1,240	2,014	1,771	2,077
Other, net	(493)	(737)	(141)	(626)
Total operating expenses	40,245	42,421	123,873	132,877
Operating (loss) income	(9,937)	7,463	(36,373)	43,529
Interest income, net	192	176	620	708
(Loss) income from continuing operations before income taxes	(9,745)	7,639	(35,753)	44,237
Income tax (benefit) provision	(3,719)	(59)	(15,575)	9,066
(Loss) income from continuing operations	(6,026)	7,698	(20,178)	35,171
Discontinued operations:				
Income from discontinued operations before income taxes		5,396		6,534
Income tax provision		1,341		1,722
Income from discontinued operations		4,055		4,812
Net (loss) income	$ (6,026)	$ 11,753	$ (20,178)	$ 39,983
(Loss) income per common share:				
Basic:				
Continuing operations	$ (0.16)	$ 0.20	$ (0.52)	$ 0.92
Discontinued operations		0.10		0.12
(Loss) income	$ (0.16)	$ 0.30	$ (0.52)	$ 1.04
Diluted :				
Continuing operations	$ (0.16)	$ 0.20	$ (0.52)	$ 0.90
Discontinued operations		0.10		0.13
(Loss) income	$ (0.16)	$ 0.30	$ (0.52)	$ 1.03
Weighted average shares outstanding:				
Basic	38,841	38,577	38,774	38,402
Diluted	38,841	39,169	38,774	39,006

The accompanying notes are an integral part of these condensed consolidated financial statements.

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Veeco Instruments Inc. and Subsidiaries

Condensed Consolidated Statements of Comprehensive (Loss) Income

(In thousands)

(Unaudited)

	For the three months ended September 30, 2013	For the three months ended September 30, 2012	For the nine months ended September 30, 2013	For the nine months ended September 30, 2012
Net (loss) income	$ (6,026)	$ 11,753	$ (20,178)	$ 39,983
Other comprehensive (loss) income, net of tax				
Available-for-sale securities				
Unrealized gain (loss) on available-for-sale securities	225	122	(15)	(129)
(Provision) benefit for income taxes	(54)	(14)	25	53
Less: Reclassification adjustments for gains included in net (loss) income	(1)	(11)	(52)	(20)
Net unrealized gain (loss) on available-for-sale securities	170	97	(42)	(96)
Foreign currency translation				
Foreign currency translation	(273)	248	(1,346)	(27)
Benefit (provision) for income taxes	176	(2)	(13)	28
Net foreign currency translation	$ (97)	$ 246	$ (1,359)	$ 1
Comprehensive (loss) income	$ (5,953)	$ 12,096	$ (21,579)	$ 39,888

The accompanying notes are an integral part of these condensed consolidated financial statements.

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Veeco Instruments Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(In thousands, except share data)

	September 30, 2013 (Unaudited)	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$ 247,666	$ 384,557
Short-term investments	322,488	192,234
Restricted cash	2,850	2,017
Accounts receivable, net	37,769	63,169
Inventories	57,585	59,807
Prepaid expenses and other current assets	36,864	32,155
Deferred income taxes	10,545	10,545
Total current assets	715,767	744,484
Property, plant and equipment at cost, net	95,698	98,302
Goodwill	55,828	55,828
Deferred income taxes	6,072	935
Intangible assets, net	18,407	20,974
Other assets	17,341	16,781
Total assets	$ 909,113	$ 937,304
Liabilities and equity		
Current liabilities:		
Accounts payable	$ 28,334	$ 26,087
Accrued expenses and other current liabilities	60,283	74,260
Deferred revenue	8,032	9,380
Income taxes payable	974	2,292
Current portion of long-term debt	285	268
Total current liabilities	97,908	112,287
Deferred income taxes	7,110	7,137
Long-term debt	1,922	2,138
Other liabilities	4,894	4,530
Total liabilities	111,834	126,092
Equity:		
Preferred stock, 500,000 shares authorized; no shares issued and outstanding		
Common stock; $.01 par value; authorized 120,000,000 shares; 39,247,833 and 39,328,503 shares issued and outstanding in 2013 and 2012, respectively	392	393
Additional paid-in capital	716,370	708,723
Retained earnings	75,945	96,123
Accumulated other comprehensive income	4,572	5,973
Total equity	797,279	811,212
Total liabilities and equity	$ 909,113	$ 937,304

The accompanying notes are an integral part of these condensed consolidated financial statements.

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Veeco Instruments Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

Commercial Automobile
35,547 8,244 27 8,271 2,236 14,766 17,002 26,816
Other
16,249 9,320 426 9,746 3,015 4,726 7,741 18,254

Net Reserves
193,116 $66,317 $1,335 $67,652 $11,877 $62,406 $74,283 186,485

Reinsurance Recoverable
181,817 175,866

Consolidated
$374,933 $362,351

Line of Business	Reserves at December 31, 2002	Re-estimated Reserves at September, 2003 on Prior Years	Development as a Percentage of Prior Year Reserves
Workers Compensation	$ 88,888	$ 86,486	(2.7)%
Commercial Multiple Peril	42,936	46,346	7.9%
Commercial Automobile	35,547	35,574	0.1%
Other	16,249	16,672	2.6%
Sub-total	183,620	185,078	0.8%
Residual Markets	9,496	9,370	(1.3)%
Total Net Reserves	$193,116	$194,448	0.7%

Workers Compensation Excluding Residual Markets

The projected net ultimate loss estimate for the workers compensation line of business excluding residual markets decreased $2.4 million, or 2.7% of net workers compensation reserves. This net overall decrease reflects an increase of $868,000 in accident year 2002 and a reduction of $2.9 million in the ultimate estimate for loss and loss adjustment for accident year 2001 and prior. The reduction in loss and allocated expense reserves primarily reflects a decrease in net ultimate loss estimates of $1.7 million in accident year 2001 and $1.4 million in accident year 2000. The increase in ultimate loss estimates for accident year 2002 reflects higher than expected emergence of claim activity, while the decreases in ultimate loss estimates for accident years 2001 and 2000 reflect lower than expected emergence of claim activity during the nine months ended September 30, 2003.

Commercial Multiple Peril

The commercial multiple peril line of business had an increase in net ultimate loss estimates of $3.4 million, or 7.9% of net commercial multiple peril reserves. The net increase was $804,000, $651,000, $1.2 million and $1.2 million in accident years 2001, 2000, 1999, and 1994, respectively. These increases in ultimate loss estimates reflect higher than expected emergence in claim activity during the nine months ended September 30, 2003. The 2002 accident year resulted in a $356,000 decrease in ultimate loss estimates. The change in ultimate net loss estimates for all other accident years was insignificant.

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Commercial Automobile

The projected net ultimate loss estimate for the commercial automobile line of business increased $27,000, or 0.1% of net commercial automobile reserves. This net overall increase reflects a reduction of $1.1 million, $690,000, and $201,000 in accident years 2002, 2000, and 1999, respectively. The reduction in accident year 2002 primarily reflects lower than expected claims activity in automobile physical damage. These reductions were offset by an increase of $2.3 million in the ultimate estimate for loss and loss adjustment for accident year 2001. The increases in accident year 2001 reflect a $1.2 million increase from one commercial trucking program which was terminated during 2001, and the remaining increases reflect changes in case reserves on programs that experienced decreases in net ultimate estimates in accident years 2000 and 1999. The change in ultimate net loss estimates for all other accident years was insignificant.

Other

The other lines of business had an increase in net ultimate loss estimates of $423,000, or 2.6% of net reserves on the other lines of business. The change reflects a reduction of $591,000 in accident year 2002, primarily from the property line of business. This decrease in ultimate loss estimates reflects lower than expected emergence in claim activity during the nine months ended September 30, 2003. This was partially offset by an increase in net ultimate loss estimates of $474,000 in the medical line of business primarily in accident year 2000 and $475,000 in accident year 1995 primarily related to legal expenses related to the recovery of losses on the surety line of business. The change in ultimate net loss estimates for all other accident years was insignificant.

Residual Markets

The change in ultimate net loss estimates for all accident years was insignificant.

Salary and Employee Benefits and Other Administrative Expenses

Salary and employee benefits for the nine months ended September 30, 2003, increased $8.2 million, or 29.3%, to $36.2 million, from $28.0 million for the comparable period in 2002. This increase is primarily the result of the hiring of employees to handle new fee-for-service agreements. In addition, this increase reflects both merit increases and variable compensation related to profitability, and a slight increase in staffing levels to support new managed programs. Other administrative expenses increased $738,000, or 4.2%, to $18.2 million, from $17.5 million for the comparable period in 2002. The increase in administrative expenses is also attributable to the new fee-for-service agreements. Salary and employee benefits and administrative expenses include both corporate overhead and the holding company expenses included in the reconciling items of the Company s segment information.

Interest Expense

Interest expense for the nine months ended September 30, 2003, decreased by $2.0 million, or 75.8%, to $656,000, from $2.7 million for the comparable period in 2002. Interest expense is primarily attributable to the Company s term loan and revolving line of credit. This decrease reflects both the reduction in the average outstanding balance and a reduction in the average interest rate. The average outstanding balance during the nine months ending September 30, 2003, was $25.9 million, compared to $47.8 million for the same period in 2002. The average interest rate in 2003 was 3.4%, compared to 7.5% in 2002. The applicable margin in the agreement, which ranges from 200 to 300 basis points above eurocurrency rates, is determined by the level of the fixed charge coverage ratio. The fixed charge coverage ratio, as defined by the credit facility, is the ratio of the non-regulated earnings before interest and taxes for the four preceding fiscal quarters to the sum of fixed charges which include interest expense, principal payments payable, stock repurchases, and dividends declared during the period. Any unused portion of the revolving credit as of the date of determination reduces the sum of these fixed charges. At September 30, 2003, this ratio was 4.6 to 1.0, compared to the covenant minimum of 1.2 to 1.0.

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On September 30, 2003, a subsidiary trust of the Company issued $10.0 million of mandatorily redeemable trust preferred securities (TPS) to a trust formed by an institutional investor. The Company s trust received a total of $9.7 million in net proceeds, after the deduction of approximately $300,000 of commissions paid to the placement agents in the transaction. The gross proceeds from the issuance of the TPS were used to purchase floating rate junior subordinated deferrable interest debentures (the Debentures) issued by the Company. The TPS have financial terms similar to those of the Debentures. The Debentures mature in 30 years and provide for interest at the three-month LIBOR plus 4.05%, payable quarterly beginning in December 2003.

Taxes

Federal income tax expense for the nine months ended September 30, 2003 was $3.9 million, or 32.8% of income before taxes. For the same period last year, the Company reflected a federal income tax benefit of ($748,000), or 46.6% of loss before taxes. The increase in tax expense is the result of an increase in earnings. The Company s effective tax rate differs from the 34% statutory rate primarily due to tax-exempt investment income. The overall change in the effective rate in comparison to the nine months ended September 30, 2002 is related to changes in the proportion of tax-exempt investment income to total underwriting results.

At September 30, 2003, the Company had a deferred tax asset of $15.5 million, $4.9 million of which is related to a net operating loss carryforward (NOL). Realization of the deferred tax asset is dependent on generating sufficient taxable income to absorb both the applicable reversing temporary differences and the NOL. At September 30, 2003, management concluded that the positive evidence supporting the generation of future taxable income sufficient to realize the deferred tax asset outweighed the negative evidence of the cumulative losses reported for the periods ended December 31, 2001, 2000, and 1999. This conclusion was based upon:

The current market conditions that supported the cumulative premium rate increases of 63.9% since the beginning of 2000 is expected to continue;

For the nine months ending September 30, 2003, loss reserves continue to stabilize with a calendar year 2003 loss and LAE ratio of 70.4% and net ultimate loss estimates on loss and LAE on prior year accident years of $1.3 million, or 0.7% of $193.1 million of net loss and LAE reserves at December 31, 2002;

The completion of the Company s exit of certain discontinued unprofitable programs. Exposures related to these programs were fully earned during the first half of 2002. Furthermore, the uncertainty of future reserve development appears to have been reduced by aggressive claims handling which reduced the number of pending claims, reserve strengthening in 2002, and a claim by claim review conducted by the Company s corporate claims department during the fourth quarter of 2002; and

Alternative tax strategies, which could generate capital gains from the potential sale of assets and/or subsidiaries.

Other Than Temporary Impairments

The Company s policy on other than temporarily impaired securities is to determine impairment based on analysis of the following factors: market value less than 80% of amortized cost for a six month period; rating downgrade or other credit event, e.g., failure to pay interest when due; financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology or discontinuance of a business segment; prospects for the issuer s industry segment; intent and ability of the Company to retain the investment for a period of time sufficient to allow for anticipated recovery in market value. Investments which are determined to be impaired are written down to their estimated net realizable value. At September 30, 2003, the Company did not hold any securities in its investment portfolio that were impaired. As of September 30, 2003, gross unrealized gains and losses on securities were $13.7 million and ($795,000), respectively. As of September 30, 2002, gross unrealized gains and losses on securities were $13.5 million and ($624,000), respectively.

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Results of Operations for the Quarters Ended September 30, 2003 and 2002

Overview

Net income for the quarter ended September 30, 2003 was $2.5 million, or $0.09 per dilutive share, compared to net loss of ($1.9 million), or ($0.06) per dilutive share, for the quarter ended September 30, 2002. This improvement reflects the absence of reserve strengthening on previously discontinued programs, the addition of new fee-for-service agreements and the Company s continued expense control initiatives. These initiatives have allowed the Company to leverage its fixed costs.

Revenues for the quarter ended September 30, 2003 increased $10.1 million, or 22.8%, to $54.5 million from $44.4 million for the comparable period in 2002.

Specialty Risk Management Operations

The following table sets forth the revenues and results from specialty risk management operations (in thousands):

	For the Quarters Ended September 30,	
	2003	2002
Revenues:		
Net earned premiums	$40,187	$31,340
Management fees	4,522	3,008
Claim fees	3,463	1,877
Loss control fees	603	637
Reinsurance brokerage	57	65
Investment income	3,215	3,738
Net realized gains on investments	299	626
Total revenue	$52,346	$41,291
Pre-tax income (loss)	$ 2,824	$ (3,425)

Revenues from specialty risk management operations increased $11.0 million, or 26.8%, to $52.3 million for the quarter ended September 30, 2003, from $41.3 million for the comparable period in 2002. This increase reflects an $8.8 million, or 28.2% increase in net earned premiums to $40.2 million in the quarter ended September 30, 2003, from $31.3 million in the comparable period in 2002. This increase reflects earned premiums on new business written in 2003 of $6.3 million and growth in existing business of $9.5 million primarily from rate increases and growth in policies. Offsetting this increase is a reduction in earned premium of $6.9 million related to programs discontinued in 1999 and programs terminated for leverage ratio purposes.

Management fees increased $1.5 million, or 50.3%, to $4.5 million for the quarter ended September 30, 2003, from $3.0 million for the comparable period in 2002. Claim fees increased $1.6 million, or 84.5%, to $3.5 million from $1.9 million for the comparable period in 2002. The increase in management fees and claim fees reflects the previously mentioned addition of new fee-for-service agreements of $1.3 million and $2.0 million, respectively. This increase in management fees and claim fees is partially offset by a decrease in discontinued programs and the result of the conversion of an existing fee-based program into an insured program within the Company s underwriting subsidiary. Loss control fees decreased $34,000, or 5.3%, to $603,000 from $637,000 for the comparable period in 2002. This decrease is mainly the result of the conversion of an existing fee-based program into an insured program.

Net investment income decreased $523,000, or 14.0%, to $3.2 million in 2003, from $3.7 million in 2002. Average invested assets increased $16.7 million, or 5.8%, to $306.5 million in 2003, from $289.8 million in 2002. The average investment yield for the third quarter of 2003 was 4.2% compared to 5.2% in 2002. The current pre-tax book yield is 4.37% and current pre-tax reinvested yield is 3.04%. The decrease in investment

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yields reflects the decline in the macro level of interest rates and the tightening of yield spreads relative to U.S. Treasuries in most sectors of the domestic taxable bond market. During the third quarter, the Company began to shift towards tax exempt securities in efforts to maximize after-tax net investment income. The effective tax rate on investment income decreased from 31.2% in 2002 to 31.0% in the third quarter of 2003. The average increase in invested assets reflects cash flows from underwriting activities (primarily the cancellation of the surplus treaty and growth in 2003 gross written premiums).

Specialty risk management operations generated pre-tax income of $2.8 million for the quarter ended September 30, 2003, compared to pre-tax loss of ($3.4 million) for the comparable period in 2002. This improvement reflects the favorable impact of the previously indicated fee-for-service agreements and improved underwriting results. The GAAP combined ratio was 103.5% for the quarter ended September 30, 2003, compared to 119.5% for the same period in 2002.

Net loss and LAE increased $1.8 million, or 7.0%, to $26.4 million for the quarter ended September 30, 2003, from $24.6 million for the same period in 2002. The Company s loss and LAE ratio decreased by 12.7 percentage points to 70.6% for the quarter ended September 30, 2003, from 83.3% for the same period in 2002. This ratio is the unconsolidated net loss and LAE in relation to net earned premium. This improvement in the loss and LAE ratio reflects rate increases achieved in 2002 and 2003, the cancellation of the surplus relief treaty, and the absence of reserve strengthening and earned premiums from discontinued programs.

The Company s expense ratio improved 3.3 percentage points to 32.9% for the quarter ended September 30, 2003, from 36.2% for the same period in 2002. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premium. The improvement reflects a reduction in gross commissions, a $437,000 adjustment related to commissions returned on a previously terminated program, and the ability to leverage fixed costs. This improvement is offset by an increase in insurance related assessments.

Agency Operations

The following table sets forth the revenues and results from agency operations (in thousands):

	For the Quarters Ended September 30,	
	2003	**2002**
Net commission	$3,527	$3,113
Pre-tax income*	$1,465	$1,275

* Excluding the allocation of corporate overhead

Revenue from agency operations, which consists primarily of agency commission revenue, increased $414,000, or 13.3%, to $3.5 million for the quarter ended September 30, 2003, from $3.1 million for the comparable period in 2002. This increase is primarily the result of $146,000 contingent commission relating to the California agency operation, and the remaining increase reflects revenue from new producers.

Agency operations generated pre-tax income of $1.5 million for the quarter ended September 30, 2003, compared to $1.3 million for the comparable period in 2002. The increase in the pre-tax margin is the result of the above mentioned contingent commission, offset by the loss of a few accounts in the Michigan agencies.

Other Items

Reserves

For the quarter ended September 30, 2003, the Company reported an decrease in net ultimate loss estimates for accident years 2002 and prior to be $(0.9 million), or (0.5)% of $193.1 million of net loss and LAE reserves at December 31, 2002. There were no significant changes in the key assumptions utilized in the analysis and calculations of the Company s reserves during 2003.

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Salary and Employee Benefits and Other Administrative Expenses

Salary and employee benefits for the quarter ended September 30, 2003 increased $3.3 million, or 35.5%, to $12.4 million, from $9.1 million for the comparable period in 2002. This increase is primarily the result of the hiring of employees to handle new fee-for-service agreements. In addition, this increase reflects both merit increases and variable compensation related to profitability, and a slight increase in staffing levels to support new managed programs. Other administrative expenses for the quarter ended September 30, 2003 decreased $161,000. This decrease in administrative expenses is attributable to a reduction in policyholder dividends and the 2002 write-off of receivable balances on a previously discontinued program, offset by the new fee-for-service agreements. Salary and employee benefits and administrative expenses include both corporate overhead and the holding company expenses included in the reconciling items of the Company s segment information.

Interest Expense

Interest expense for the quarter ended September 30, 2003 decreased by $375,000, or 64.4%, to $207,000, from $582,000 for the comparable period in 2002. Interest expense is primarily attributable to the Company s term loan and revolving line of credit. This decrease reflects both the reduction in the average outstanding balance and a reduction in the average interest rate. The average outstanding balance during the quarter ended September 30, 2003, was $20.0 million, compared to $34.6 million for the same period in 2002. The average interest rate in 2003 was 4.1%, compared to 6.7% in 2002. The applicable margin in the agreement, which ranges from 200 to 300 basis points above eurocurrency rates, is determined by the level of the fixed charge coverage ratio. The fixed charge coverage ratio, as defined by the credit facility, is the ratio of the non-regulated earnings before interest and taxes for the four preceding fiscal quarters to the sum of fixed charges which include interest expense, principal payments payable, stock repurchases, and dividends declared during the period. Any unused portion of the revolving credit as of the date of determination reduces the sum of these fixed charges. This ratio at September 30, 2003, was 4.6 to 1.0, compared to the covenant minimum of 1.2 to 1.0.

On September 30, 2003, a subsidiary trust of the Company issued $10.0 million of mandatorily redeemable trust preferred securities (TPS) to a trust formed by an institutional investor. The Company s trust received a total of $9.7 million in net proceeds, after the deduction of approximately $300,000 of commissions paid to the placement agents in the transaction. The gross proceeds from the issuance of the TPS were used to purchase floating rate junior subordinated deferrable interest debentures (the Debentures) issued by the Company. The TPS have financial terms similar to those of the Debentures. The Debentures mature in 30 years and provide for interest at the three-month LIBOR plus 4.05%, payable quarterly beginning in December 2003.

Taxes

Federal income tax expense for the quarter ended September 30, 2003 was $1.2 million, or 33.1% of income before taxes. For the same quarter last year, the Company reflected a federal income tax benefit of ($1.0 million), or 34.8% of loss before taxes. The increase in tax expense is the result of an increase in earnings. The Company s effective tax rate differs from the 34% statutory rate primarily due to tax-exempt investment income. The overall change in the effective rate in comparison to the quarter ended September 30, 2002 is related to changes in the proportion of tax-exempt investment income to total underwriting results.

Liquidity and Capital Resources

The principal sources of funds for the Company and its subsidiaries are insurance premiums, investment income, proceeds from the maturity and sale of invested assets, risk management fees, and agency commissions. Funds are primarily used for the payment of claims, commissions, salaries and employee benefits, other operating expenses, shareholder dividends, and debt service. The Company generates operating cash flow from non-regulated subsidiaries in the form of commission revenue, outside management fees, and intercompany management fees. These sources of income are used to meet debt service, shareholders

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dividends, and other operating expenses of the holding company and the non-regulated subsidiaries, which have been set forth in the table below for the periods ending September 30, 2003 and 2002.

	For the Nine Months Ended September 30,	
	2003	**2002**
Net income (loss)	$7,935	$ (859)
Regulated Subsidiaries		
Net income (loss)	$3,029	$(2,426)
Non-regulated Subsidiaries		
Net income	$4,906	$ 1,567
Interest, depreciation, and amortization	2,190	4,648
Non-regulated net income, excluding interest, depreciation, and amortization	$7,096	$ 6,215

	For the Quarters Ended September 30,	
	2003	**2002**
Net income (loss)	$2,500	$(1,891)
Regulated Subsidiaries		
Net income (loss)	$ 771	$(1,792)
Non-regulated Subsidiaries		
Net income (loss)	$1,729	$ (99)
Interest, depreciation, and amortization	759	1,224
Non-regulated net income, excluding interest, depreciation, and amortization	$2,488	$ 1,125

Cash flow provided by operations for the nine months ended September 30, 2003 was $31.6 million, compared to cash flow provided by operations of $879,000 for the comparable period in 2002. The increase in cash flow from operations primarily reflects an increase in earnings and growth in written premiums.

On September 30, 2003, a subsidiary trust of the Company issued $10.0 million of mandatorily redeemable trust preferred securities (TPS) to a trust formed by an institutional investor. The Company s trust received a total of $9.7 million in net proceeds, after the deduction of approximately $300,000 of commissions paid to the placement agents in the transaction. The Company contributed $6.3 million of the proceeds to its insurance company subsidiaries and the remaining balance will be used for general corporate purposes. The Debenture matures in 30 years and provides for interest at the three-month LIBOR plus 4.05%, payable quarterly beginning in December 2003.

The Company has a credit agreement which includes a term loan and a revolving line of credit. This credit agreement consists of a $20.0 million term loan and a revolving line of credit for up to $8.0 million. The Company uses the revolving line of credit to meet short-term working capital needs. At September 30, 2003, the Company s term loan had an outstanding balance of $15.5 million. The Company had no outstanding balance on the revolving line of credit at September 30, 2003. At December 31, 2002, the outstanding balance on the term loan and revolving line of credit was $18.8 million and $5.3 million, respectively. The term loan calls for quarterly amortization through July 1, 2006, at which time the term loan will be paid in full. The quarterly amortization requires payments of $1.0 million on April 1, 2003 and July 1, 2003; $1.5 million on October 1, 2003; and $1.2 million for the remaining quarterly amortization payments in 2004, 2005, and 2006, with a final payment of $1.5 million on July 1, 2006. The revolving line of credit will expire on July 1, 2004, and is thereafter renewable on an annual basis.

The Company made principal payments of $1.2 million on January 1, 2003, $1.0 million on April 1, 2003 and July 1, 2003, and $1.5 million on October 1, 2003, on the term loan.

Both the term loan and revolving line of credit provide for interest at a variable rate based, at the Company s option, upon either the prime rate or eurocurrency rate. The applicable margin, which ranges from 200 to 300 basis points above eurocurrency rates, is determined by the level of the fixed charge coverage ratio. Of all the covenants, the most restrictive covenant is the fixed charge coverage ratio. The fixed charge coverage ratio, as defined by the credit facility, is the ratio of the non-regulated earnings before interest and taxes for the four preceding fiscal quarters to the sum of fixed charges which include interest expense, principal payments payable, stock repurchases, and dividends declared during the period. Any unused portion of the revolving credit as of the date of determination reduces the sum of these fixed charges. At September 30, 2003, this ratio was 4.6 to 1.0, compared to the covenant minimum of 1.2 to 1.0.

As of September 30, 2003, the Company was in compliance with all debt covenants.

In addition, a non-insurance premium finance subsidiary of the Company maintains a line of credit with a bank, which permits borrowings up to 80% of the accounts receivable, which collateralize the line of credit. At September 30, 2003, this line of credit had an outstanding balance of $3.8 million.

At September 30, 2003, shareholders equity was $154.0 million, or $5.31 per common share, compared to $147.4 million, or $4.98 per common share, at December 31, 2002.

On September 17, 2002, the Company s Board of Directors authorized management to repurchase up to 1,000,000 shares of the Company s common stock in market transactions for a period not to exceed twenty-four months. On August 6, 2003, the Company s Board of Directors authorized management to repurchase up to an additional 1,000,000 shares of the Company s common stock under the existing share repurchase plan. As of September 30, 2003, the Company repurchased and retired 764,800 shares of common stock for a total cost of approximately $2.0 million. The Company did not repurchase any common stock during the quarter ended September 30, 2003. As of November 6, 2003, the Company repurchased and retired 764,800 shares of common stock for a total cost of approximately $2.0 million.

A significant portion of the Company s consolidated assets represent assets of the Insurance Company Subsidiaries that at this time, without prior approval of the Michigan Office of Financial and Insurance Services (OFIS), cannot be transferred to the holding company in the form of dividends, loans or advances. The restriction on the transferability to the holding company from its Insurance Company Subsidiaries is limited by Michigan insurance regulatory guidelines which, in general, are as follows: the maximum discretionary dividend that may be declared, based on data from the preceding calendar year, is the greater of each insurance company s net income (excluding realized capital gains) or ten percent of the insurance company s surplus (excluding unrealized gains). These dividends are further limited by a clause in the Michigan law that prohibits an insurer from declaring dividends, except from surplus earnings of the company. Earned surplus balances are calculated on a quarterly basis. Since Star is the parent insurance company, its maximum dividend calculation represents the combined Insurance Company Subsidiaries surplus. Based upon the 2002 statutory financial statements, Star may only pay dividends to the Company during 2003 with the prior approval of OFIS. Star s earned surplus position at December 31, 2002 was negative $24.3 million. At September 30, 2003, earned surplus was negative $26.2 million. The increase in negative earned surplus was anticipated with the statutory recognition of acquisition costs when premiums are written vs. earned. No statutory dividends were paid in 2002.

Regulatory and Rating Issues

The National Association of Insurance Commissioners (NAIC) has adopted a risk-based capital (RBC) formula to be applied to all property and casualty insurance companies. The formula measures required capital and surplus based on an insurance company s products and investment portfolio and is used as a tool to evaluate the capital of regulated companies. The RBC formula is used by state insurance regulators to monitor trends in statutory capital and surplus for the purpose of initiating regulatory action. In general, an insurance company must submit a calculation of its RBC formula to the insurance department of its state of domicile as of the end of the previous calendar year. These laws require increasing degrees of regulatory oversight and intervention as an insurance company s RBC declines. The level of regulatory oversight ranges from requiring the insurance company to inform and obtain approval from the domiciliary insurance commissioner of a comprehensive financial plan for increasing its RBC to mandatory regulatory intervention requiring an insurance company to be placed under regulatory control in a rehabilitation or liquidation proceeding.

At December 31, 2002, all of the Insurance Company Subsidiaries were in compliance with RBC requirements. Star reported statutory surplus of $93.8 million at December 31, 2002, compared to the threshold requiring the minimum regulatory involvement of $49.7 million in 2002. At September 30, 2003, Star s statutory surplus was $98.2 million. Statutory accounting principles differ in some respects from generally accepted accounting principles (GAAP). These differences, among other differences, include the costs of acquiring and renewing business. Under statutory accounting principles these acquisition costs are expensed as premium is written, while under GAAP these costs are deferred and recognized as premium is earned over the terms of the policies or reinsurance treaties to which the costs relate. At September 30, 2003, deferred policy acquisition costs increased $6.8 million, or 56.3%, to $19.0 million, compared to $12.1 million at December 31, 2002. This increase reflects the increase in gross unearned premiums of $43.0 million, or 62.5%, to $111.6 million at September 30, 2003, compared to $68.7 million at December 31, 2002.

Insurance operations are subject to various leverage tests (e.g. premium to statutory surplus ratios), which are evaluated by regulators and rating agencies. The Company s targets for gross and net written premium to statutory surplus are 3.0 to 1 and 2.0 to 1, respectively. As of September 30, 2003, on a statutory consolidated basis, gross and net premium leverage ratios were 2.4 to 1.0 and 1.8 to 1.0, respectively.

The Insurance Company Subsidiaries A.M. Best financial strength rating is a B+ (Very Good) with a positive outlook. A positive outlook is placed on a company s rating if its financial and market trends are favorable, relative to its current rating level.

New Accounting Pronouncements

The Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards (SFAS) No. 148 Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123 , for periods starting after December 15, 2003, or thereafter. SFAS No. 148 provides three optional transition methods for entities that decide to voluntarily adopt the fair value recognition principles of SFAS No 123, Accounting for Stock-Based Compensation , and modifies the disclosure requirements of that Statement. Under the prospective method, stock-based compensation expense is recognized for awards granted after the beginning of the fiscal year in which the change is made. The modified prospective method recognizes stock-based compensation expense related to new and unvested awards in the year of change equal to that which would have been recognized had SFAS No. 123 been adopted as of its effective date, fiscal years beginning after December 15, 1994. The retrospective restatement method recognizes stock compensation costs for the year of change and restates financial statements for all prior periods presented as though the fair value recognition provisions of SFAS No. 123 had been adopted as of its effective date.

As of January 1, 2003, the Company adopted the requirements of SFAS No. 148 utilizing the prospective method. Under SFAS 148, compensation expense of $155,000 and $35,000, has been recorded for stock options granted in the nine months and quarter ended September 30, 2003, respectively. No compensation cost has been recorded for stock option grants issued during 2002 as the market value equaled the exercise price at the date of grant.

On May 15, 2003, the FASB issued SFAS No. 150 Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. The statement requires issuers to classify as liabilities (or assets in some circumstances) three classes of freestanding financial instruments that embody obligations for the issuer. Generally, the statement is effective for financial instruments entered into or modified after May 31, 2003 and is otherwise effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this statement did not have an impact on our financial statements.

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In November 2002, the FASB issued FASB Interpretation (FIN) No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN No. 45 clarifies the requirements of SFAS No. 5, Accounting for Contingencies , relating to a guarantor s accounting for, and disclosure of, the issuance of certain types of guarantees. For certain guarantees issued after December 31, 2002, FIN No. 45 requires a guarantor to recognize, upon issuance of a guarantee, a liability for the fair value of the obligations it assumes under the guarantee. Guarantees issued prior to January 1, 2003 are not subject to liability recognition, but are subject to expanded disclosure requirements. The adoption of FIN No. 45 did not have a material impact on our financial statements.

In January 2003, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities. The primary objective of FIN No. 46 is to provide guidance on the identification of, and financial reporting for, entities over which control is achieved through means other than voting rights; such entities are known as variable interest entities. FIN No. 46 requires variable interest entities to be consolidated by the primary beneficiary of the variable interest entities and expands disclosure requirements for both variable interest entities that are consolidated as well as those within which an enterprise holds a significant variable interest. FIN No. 46 is required to be adopted by December 31, 2003. We are currently evaluating the impact FIN No. 46 will have on our financial statements.

Item 3. ***Quantitative and Qualitative Disclosures about Market Risk***

No material changes since December 31, 2002 Annual Report on Form 10-K.

Item 4. ***Controls and Procedures***

The Company carried out an evaluation, as of September 30, 2003, under the supervision and with the participation of the Company s management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective to ensure that all material information relating to the Company (including its consolidated subsidiaries) required to be included in this quarterly report has been made known in a timely manner. There have been no significant changes in the Company s internal controls or in other factors that could significantly affect these internal controls during the quarter ended September 30, 2003.

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PART II OTHER INFORMATION

Item 1. ***Legal Proceedings***

The information required by this item is included under Note 7 of the Company s Form 10-Q for the nine months ended September 30, 2003, which is hereby incorporated by reference.

Item 2. ***Changes in Securities and Use of Proceeds***

In September 2003, a subsidiary trust of the Company issued $10 million of mandatorily redeemable trust preferred securities (TPS) to a trust formed by an institutional investor, Dekania CDO I, Ltd. The Company s trust received a total of $9.7 million in net proceeds, after the deduction of a total of approximately $300,000 of commissions paid to the placement agent in the transaction. The proceeds of the issuance were invested in the Debentures issued by the Company, as described in Note 4 of the consolidated financial statements included elsewhere in this report. The Company s trust sold the TPS in a non-public offering pursuant to Section 4(2) of the Securities Act of 1933, as amended.

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

(A) The following documents are filed as part of this Report:

Exhibit No.	Description
4.1	TPS Indenture
10.1	Third Amendment to Restated Credit Agreement between Meadowbrook Insurance Group, Inc. and Comerica Bank, dated September 29, 2003.
10.2	TPS Purchase Agreement
10.3	TPS Amended and Restated Declaration of Trust
10.4	TPS Guaranty Agreement
31.1	Certification of Robert S. Cubbin, Chief Executive Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).
31.2	Certification of Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Robert S. Cubbin, Chief Executive Officer of the Corporation.
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation.

(B) Reports on Form 8-K:

The Registrant filed a Current Report on Form 8-K dated August 12, 2003 for the purpose of furnishing the Company s second quarter 2003 earnings release.

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SIGNATURES

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

MEADOWBROOK INSURANCE GROUP, INC.

By: /s/ KAREN M. SPAUN

Senior Vice President and
Chief Financial Officer

Dated: November 12, 2003

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