

21ST CENTURY INSURANCE GROUP  
Form 10-Q  
April 27, 2006

---

---

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

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended March 31, 2006

**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 0-6964

**21ST CENTURY INSURANCE GROUP**  
(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of incorporation or  
organization)

**95-1935264**  
(I.R.S. Employer Identification No.)

**6301 Owensmouth Avenue**  
**Woodland Hills, California**  
(Address of principal executive offices)

**91367**  
(Zip Code)

**(818) 704-3700**  
(Registrant's telephone number, including area  
code)

**www.21st.com**  
(Registrant's web site)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Edgar Filing: 21ST CENTURY INSURANCE GROUP - Form 10-Q

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares outstanding of the issuer's common stock as of April 12, 2006 was 86,107,238.

---

---

---

**TABLE OF CONTENTS**

Description	Page Number
<b>PART I - FINANCIAL INFORMATION</b>	
Item 1.	<u>Financial Statements</u> 2
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> 17
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u> 31
Item 4.	<u>Controls and Procedures</u> 33
<b>PART II - OTHER INFORMATION</b>	
Item 1.	<u>Legal Proceedings</u> 33
Item 1A.	<u>Risk Factors</u> 33
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u> 33
Item 3.	<u>Defaults Upon Senior Securities</u> 33
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u> 33
Item 5.	<u>Other Information</u> 33
Item 6.	<u>Exhibits</u> 33
	<b><u>SIGNATURES</u></b> 34
	<b><u>EXHIBIT INDEX</u></b> 35
31.1	Certification of Principal Executive Officer
31.2	Certification of Principal Financial Officer
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Table of Contents**PART I - FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****21ST CENTURY INSURANCE GROUP  
CONDENSED CONSOLIDATED BALANCE SHEETS**

Unaudited

*AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA***March 31, 2006**    December 31, 2005**Assets**

Fixed maturity investments available-for-sale, at fair value (amortized cost: \$1,467,093 and \$1,365,948)	<b>\$1,434,761</b>	\$1,354,707
Equity securities available-for-sale, at fair value (cost: \$848 and \$49,210)	<b>850</b>	47,367
Total investments	<b>1,435,611</b>	1,402,074
Cash and cash equivalents	<b>35,146</b>	68,668
Accrued investment income	<b>17,333</b>	16,585
Premiums receivable	<b>107,231</b>	100,900
Reinsurance receivables and recoverables	<b>6,223</b>	6,539
Prepaid reinsurance premiums	<b>2,023</b>	1,946
Deferred income taxes	<b>59,307</b>	56,209
Deferred policy acquisition costs	<b>62,919</b>	59,939
Leased property under capital lease, net of deferred gain of \$1,423 and \$1,534 and net of accumulated amortization of \$38,273 and \$36,995	<b>21,587</b>	22,651
Property and equipment, at cost less accumulated depreciation of \$94,976 and \$89,595	<b>147,047</b>	145,811
Other assets	<b>42,183</b>	38,907
Total assets	<b>\$1,936,610</b>	\$1,920,229
<b>Liabilities and stockholders' equity</b>		
Unpaid losses and loss adjustment expenses	<b>\$ 508,428</b>	\$ 523,835
Unearned premiums	<b>331,152</b>	319,676
Debt	<b>124,796</b>	127,972
Claims checks payable	<b>40,609</b>	42,681
Reinsurance payable	<b>755</b>	643
Other liabilities	<b>94,057</b>	75,450
Total liabilities	<b>1,099,797</b>	1,090,257
Commitments and contingencies		
Stockholders' equity:		
Common stock, par value \$0.001 per share; 110,000,000 shares authorized; shares issued 86,101,668 and 85,939,889	<b>86</b>	86
Additional paid-in capital	<b>430,360</b>	425,454
Treasury stock, at cost; 5,929 shares	<b>(84)</b>	(84)
Retained earnings	<b>429,343</b>	414,898
Accumulated other comprehensive loss	<b>(22,892)</b>	(10,382)
Total stockholders' equity	<b>836,813</b>	829,972
Total liabilities and stockholders' equity	<b>\$1,936,610</b>	\$1,920,229

*See accompanying Notes to Condensed Consolidated Financial Statements.*



Table of Contents**21ST CENTURY INSURANCE GROUP  
CONDENSED CONSOLIDATED STATEMENTS OF  
OPERATIONS**

Unaudited

*AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA**Three Months Ended March 31,*

	<b>2006</b>	2005
<b>Revenues</b>		
Net premiums earned	\$ 325,824	\$ 336,364
Net investment income	17,755	17,037
Net realized investment losses	(1,067)	(460)
Total revenues	342,512	352,941
<b>Losses and expenses</b>		
Net losses and loss adjustment expenses	236,496	251,031
Policy acquisition costs	59,333	64,323
Other underwriting expenses	12,600	7,358
Interest and fees expense	1,898	2,057
Total losses and expenses	310,327	324,769
Income before provision for income taxes	32,185	28,172
Provision for income taxes	10,868	8,735
Net income	\$ 21,317	\$ 19,437
<b>Earnings per common share</b>		
Basic and diluted	\$ 0.25	\$ 0.23
Weighted-average shares outstanding – basic	85,868,878	85,520,909
Weighted-average shares outstanding – diluted	86,517,163	85,714,469

*See accompanying Notes to Condensed Consolidated Financial Statements.*

Table of Contents**21ST CENTURY INSURANCE GROUP  
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**

Unaudited

<i>AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA</i>	Common Stock \$0.001 par value		<i>Additional Paid-in Capital</i>	<i>Treasury Stock</i>	<i>Retained Earnings</i>	<i>Accumulated Other Comprehensive Loss</i>	<i>Total</i>
	<i>Issued Shares</i>	<i>Amount</i>					
Balance - January 1, 2006	85,939,889	\$ 86	\$425,454	\$ (84)	\$414,898	\$(10,382)	\$829,972
Comprehensive income (loss)					21,317 <sup>(1)</sup>	(12,510) <sup>(2)</sup>	8,807
Cash dividends declared on common stock (\$0.08 per share)					(6,872)		(6,872)
Exercise of stock options	58,229		718				718
Issuance of restricted stock	103,550						—
Stock-based compensation cost			4,099				4,099
Excess tax benefits of stock-based compensation			89				89
Balance - March 31, 2006	86,101,668	\$ 86	\$430,360	\$ (84)	\$429,343	\$(22,892)	\$836,813

<sup>(1)</sup> Net income for the three months ended March 31, 2006.<sup>(2)</sup> Net change in accumulated other comprehensive loss follows:

	<i>Three Months Ended March 31, 2006</i>
Unrealized holding losses arising during the period, net of tax benefit of \$(7,109)	\$(13,204)
Reclassification adjustment for investment losses included in net income, net of tax expense of \$373	694
<b>Total</b>	<b>\$(12,510)</b>

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents**21ST CENTURY INSURANCE GROUP  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

Unaudited

*AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA**Three Months Ended March 31,*

	2006	2005
<b>Operating activities</b>		
Net income	\$ 21,317	\$ 19,437
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,661	6,602
Net amortization of investment premiums and discounts	2,007	2,371
Stock-based compensation cost	4,099	34
Provision for deferred income taxes	2,820	3,459
Realized losses on sale of investments	1,067	460
<b>Changes in assets and liabilities</b>		
Premiums receivable	(6,331)	(8,496)
Deferred policy acquisition costs	(2,980)	(8,636)
Reinsurance receivables and recoverables	352	1,181
Federal income taxes	4,529	10,407
Other assets	(2,880)	2,883
Unpaid losses and loss adjustment expenses	(15,407)	(5,371)
Unearned premiums	11,476	14,579
Claims checks payable	(2,072)	1,277
Other liabilities	14,079	(743)
Net cash provided by operating activities	38,737	39,444
<b>Investing activities</b>		
Purchases of:		
Fixed maturity investments available-for-sale	(146,738)	(31,759)
Equity securities available-for-sale	(35,627)	(70,902)
Property and equipment	(6,627)	(7,629)
Maturities and calls of fixed maturity investments available-for-sale	21,139	10,775
Sales of:		
Fixed maturity investments available-for-sale	21,022	2,196
Equity securities available-for-sale	83,989	69,539
Net cash used in investing activities	(62,842)	(27,780)
<b>Financing activities</b>		
Repayment of debt	(3,352)	(2,954)
Dividends paid (per share: \$0.08 and \$0.04)	(6,872)	(3,422)
Proceeds from the exercise of stock options	718	1,308
Excess tax benefits from stock-based compensation	89	—
Net cash used in financing activities	(9,417)	(5,068)
Net (decrease) increase in cash and cash equivalents	(33,522)	6,596
Cash and cash equivalents, beginning of period	68,668	34,697
Cash and cash equivalents, end of period	\$ 35,146	\$ 41,293

**Supplemental information:**



Edgar Filing: 21ST CENTURY INSURANCE GROUP - Form 10-Q

Income taxes paid	\$ 3,519	\$ 6,784
Interest paid	388	547

*See accompanying Notes to Condensed Consolidated Financial Statements.*

5

---

Table of Contents

**21ST CENTURY INSURANCE GROUP**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**March 31, 2006**  
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

**NOTE 1. FINANCIAL STATEMENT PRESENTATION**

**General**

21st Century Insurance Group and subsidiaries (the “Company”) prepared the accompanying unaudited condensed consolidated financial statements in accordance with the rules and regulations of the Securities and Exchange Commission for interim reporting. As permitted under those rules and regulations, certain notes or other information that are normally required by accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted if they substantially duplicate the disclosures contained in the annual audited consolidated financial statements. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2005.

These unaudited condensed consolidated financial statements include all adjustments (including normal, recurring accruals) that are considered necessary for the fair presentation of our financial position and results of operations in accordance with GAAP. Intercompany accounts and transactions have been eliminated in consolidation. Operating results for the three-month period ended March 31, 2006 are not necessarily indicative of results that may be expected for the remaining interim periods or the year as a whole.

Certain prior period balances have been reclassified to conform to the current period presentation.

**Earnings Per Share (“EPS”)**

For each of the quarters ended March 31, 2006 and 2005, the numerator for the calculation of both basic and diluted earnings per share is equal to net income reported for that period. The difference between basic and diluted EPS denominators is due to dilutive common stock equivalents (stock options and restricted stock). Basic earnings per share excludes dilution and reflects net income divided by the weighted-average shares of common stock outstanding during the periods presented. The denominator for the computation of basic EPS was 85,868,878 shares and 85,520,909 for the three months ended March 31, 2006 and 2005, respectively.

Diluted earnings per share is based upon the weighted-average shares of common stock and dilutive common stock equivalents outstanding during the periods presented. Common stock equivalents arising from dilutive stock options and restricted common stock are computed using the treasury stock method. For the three months ended March 31, 2006 and 2005, this amounted to 86,517,163 shares and 85,714,469 shares, respectively, which include 648,285 and 193,560 dilutive common stock equivalents, respectively.

Options to purchase an aggregate of 4,552,553 and 7,208,291 shares of common stock for the three months ended March 31, 2006 and 2005, respectively, were not included in the computation of diluted earnings per share because the options’ exercise prices were greater than the average market prices of the common stock for each respective period. These options expire at various points in time through 2016.

**Stock-Based Compensation**

Prior to January 1, 2006, the Company accounted for its stock-based compensation plans under the measurement and recognition provisions of Accounting Principles Board Opinion No. (“APB”) 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by Statement of Financial Accounting Standards No. (“FAS”) 123, *Accounting for Stock-Based Compensation*. Under the intrinsic-value method prescribed by APB 25, compensation

cost for stock options was measured at the date of grant as the excess, if any, of the quoted market price of the Company's stock over the exercise price of the options. All employee stock options were granted at or above the grant date market price. Accordingly, no compensation cost was recognized for fixed stock option grants in prior periods; however, stock-based compensation was included as a pro forma disclosure in the consolidated financial statement footnotes.

6

---

Table of Contents

**21ST CENTURY INSURANCE GROUP**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**March 31, 2006**

DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

Effective January 1, 2006, the Company adopted FAS 123 (revised 2004), *Share-Based Payment* ("FAS 123R"), which requires all stock-based payments to employees, including grants of employee stock options, to be recognized in the statements of operations based on their fair values. Determining the fair value of share-based awards at the grant date requires judgment in estimating the volatility and dividends over the expected term that the stock options will be outstanding prior to exercise. Judgment is also required in estimating the amount of stock-based awards expected to be forfeited prior to vesting. If actual forfeitures differ significantly from these estimates, stock-based compensation expense could be materially impacted.

**Recent Accounting Standards**

Statement of Position ("SOP") 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*, becomes effective January 1, 2007. SOP 05-1 provides guidance on accounting for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FAS 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. The SOP defines an internal replacement as a modification in product benefits, features, rights, or coverage that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. The Company is currently assessing the effect of implementing this guidance.

**NOTE 2. STOCK-BASED COMPENSATION**

On January 1, 2006, the Company adopted FAS 123R and began recognizing the cost of all employee stock options on a straight-line basis over their respective vesting periods, net of estimated forfeitures, using the modified-prospective transition method. Under this transition method, 2006 results include: (1) stock-based compensation cost related to stock options granted on or prior to, but not vested as of, December 31, 2005, based on the grant date fair value originally estimated for the pro forma disclosures in accordance with the original provisions of FAS 123 and (2) all stock-based payments granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of FAS 123R. Results for prior periods have not been restated.

FAS 123R also prescribes the recognition of expense using the non-substantive vesting period approach for grants made after December 31, 2005. This expense attribution method requires recognition of compensation expense from the date of grant to the earlier of the vesting date or the date retirement eligibility is achieved for awards with retirement eligibility options. The use of the non-substantive vesting period approach will not affect the overall amount of compensation expense recognized, but could accelerate the recognition of expense. The Company will continue to follow the nominal vesting approach for the remaining portion of those outstanding awards that were unvested and granted prior to January 1, 2006, and will accordingly recognize expense from the grant date to the earlier of the actual date of retirement or the vesting date. This change resulted in the acceleration of \$0.7 million expense for the three months ended March 31, 2006.

Stock-based awards are forfeited if officers and employees terminate prior to the vesting date. Any compensation cost previously recognized with respect to unvested stock awards is reversed in the period of forfeiture. Upon share option exercise or restricted share unit conversion, the Company issues new shares, unless the Company elects to use available treasury shares. The Company records forfeitures of restricted stock as treasury share repurchases.

Prior to the adoption of FAS 123R, the Company applied APB 25, and related Interpretations, in accounting for its stock-based compensation plans. All employee stock options were granted at or above the grant date market price. Accordingly, no compensation cost was recognized for stock option grants in prior periods. Also, the Company previously presented all benefits of tax deductions resulting from the exercise of share-based compensation as operating cash flows in the Condensed Consolidated Statement of Cash Flows. FAS 123R requires the benefits of tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. First quarter 2006 results included \$89 thousand of excess tax benefits as a financing cash inflow.

Table of Contents

**21ST CENTURY INSURANCE GROUP**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**March 31, 2006**

DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

**2004 Stock Option Plan**

The stockholders approved the 2004 Stock Option Plan (the "2004 Plan") at the Annual Meeting of Shareholders on May 26, 2004. The 2004 Plan supersedes the 1995 Stock Option Plan, which remains in effect only as to outstanding awards under it. The 2004 Plan authorizes a Committee of the Board of Directors to grant stock options in respect of 4,000,000 shares to eligible employees and nonemployee directors, subject to the terms of the 2004 Plan.

Additionally, under the 2004 Plan, the Committee may grant stock options in respect of shares that were subject to outstanding awards under the 1995 Stock Option Plan to the extent such awards expire, are terminated, are canceled, or are forfeited for any reason without shares being issued.

A summary of securities issuable and issued for the Company's stock option plans at March 31, 2006, follows:

<i>AMOUNTS IN THOUSANDS</i>	<i>1995 Stock Option Plan</i>	<i>2004 Stock Option Plan</i>
Total number of securities authorized	10,000	4,000
Number of securities issued	(944)	—
Number of securities issuable upon the exercise of all outstanding options	(6,782)	(3,640)
Number of securities forfeited	(2,559)	(68)
Number of forfeited securities returned to plan	2,559	68
Unused options assumed by 2004 Stock Option Plan	(2,274)	2,274
Number of securities remaining available for future grants under each plan	—	2,634

A summary of the Company's stock option activity for the three months ended March 31, 2006, and related information follows:

<i>AMOUNTS IN THOUSANDS, EXCEPT PRICE DATA</i>	<i>Number of Options</i>	<i>Weighted-Average Exercise Price</i>
Options outstanding December 31, 2005	8,869	\$ 16.22
Granted in 2006	1,814	16.62
Exercised in 2006	(58)	16.06
Forfeited in 2006	(3)	13.88
Canceled in 2006	(200)	