HealthMarkets, Inc.
Form 10-Q
May 14, 2010

Table of Contents

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

FORM 10-Q

þ **QUARTER REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2010

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: 001-14953

HEALTHMARKETS, INC.
(Exact name of registrant as specified in its charter)

Delaware	**75-2044750**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

9151 Boulevard 26, North Richland Hills, Texas 76180
(Address of principal executive offices, zip code)
(817) 255-5200
(Registrant s phone number, including area code)

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

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 (§232.405 of this chapter) during the preceding 1 months (or for such shorter period that the registrant was required to submit and post such files). Yes o 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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ (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 þ

On April 30, 2010 the registrant had 27,652,480 outstanding shares of Class A-1 Common Stock, $.01 Par Value, and 2,655,198 outstanding shares of Class A-2 Common Stock, $.01 Par Value.

HEALTHMARKETS, INC.
and Subsidiaries
First Quarter 2010 Form 10-Q
TABLE OF CONTENTS

HEALTHMARKETS, INC.
and Subsidiaries

Table of Contents

HEALTHMARKETS, INC.
and Subsidiaries
CONSOLIDATED CONDENSED BALANCE SHEETS
(In thousands, except per share data)

	March 31, 2010 (Unaudited)	December 31, 2009
ASSETS		
Investments:		
Securities available for sale		
Fixed maturities, at fair value (cost: 2010 $784,952; 2009 $742,630)	$ 809,064	$ 756,180
Equity securities, at fair value (cost: 2010 $243; 2009 $234)	243	234
Trading securities, at fair value	9,903	9,893
Short-term and other investments, at fair value (cost: 2010 $260,370; 2009 $370,676)	261,778	371,534
Total investments	1,080,988	1,137,841
Cash and cash equivalents	15,789	17,406
Student loan receivables	67,040	69,911
Restricted cash	9,589	8,647
Investment income due and accrued	12,944	10,464
Reinsurance recoverable ceded policy liabilities	359,865	361,305
Agent and other receivables	22,590	26,390
Deferred acquisition costs	55,498	64,339
Property and equipment, net	48,547	48,690
Goodwill and other intangible assets	85,118	85,973
Recoverable federal income taxes	14,683	17,879
Other assets	29,896	22,653
	$ 1,802,547	$ 1,871,498
LIABILITIES AND STOCKHOLDERS EQUITY		
Policy liabilities:		
Future policy and contract benefits	$ 457,051	$ 462,217
Claims	324,025	339,755
Unearned premiums	42,865	46,309
Other policy liabilities	8,025	8,247
Accounts payable and accrued expenses	54,473	65,692
Other liabilities	67,146	74,929
Deferred federal income taxes	56,798	51,978
Debt	553,420	481,070
Student loan credit facility	74,900	77,350
Net liabilities of discontinued operations	1,622	1,752
	1,640,325	1,609,299

Commitments and Contingencies (Note 9)

Stockholders equity:		
Preferred stock, par value $0.01 per share authorized 10,000,000 shares, none issued		
Common stock, Class A-1, par value $0.01 per share authorized 90,000,000 shares, 27,608,371 issued and 27,598,435 outstanding at March 31, 2010; 27,608,371 issued and 27,608,371 outstanding at December 31, 2009. Class A-2, par value $0.01 per share authorized 20,000,000 shares, 4,026,104 issued and 2,963,895 outstanding at March 31, 2010; 4,026,104 issued and 2,565,874 outstanding at December 31, 2009	316	316
Additional paid-in capital	42,787	42,342
Accumulated other comprehensive income	12,272	3,739
Retained earnings	127,761	246,427
Treasury stock, at cost (9,936 Class A-1 common shares and 1,062,209 Class A-2 common shares at March 31, 2010; -0- Class A-1 common shares and 1,460,230 Class A-2 common shares at December 31, 2009)	(20,914)	(30,625)
	162,222	262,199
	$ 1,802,547	$ 1,871,498

See Notes to Consolidated Condensed Financial Statements.

Table of Contents

HEALTHMARKETS, INC.
and Subsidiaries
CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(In thousands, except per share data)
(Unaudited)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
REVENUE		
Health premiums	$ 205,773	$ 263,140
Life premiums and other considerations	651	718
	206,424	263,858
Investment income	11,271	10,316
Other income	13,649	17,241
Total other-than-temporary impairment losses		(1,395)
Portion of loss recognized in other comprehensive income (before taxes)		
Net impairment losses recognized in earnings		(1,395)
Realized gains, net	219	22
	231,563	290,042
BENEFITS AND EXPENSES		
Benefits, claims, and settlement expenses	121,796	167,599
Underwriting, acquisition and insurance expenses	52,999	80,900
Other expenses	46,860	20,006
Interest expense	8,192	9,509
	229,847	278,014
Income from continuing operations before income taxes	1,716	12,028
Federal income tax expense	948	4,005
Income from continuing operations	768	8,023
Income from discontinued operations, (net of income tax expense of $8 and $19 in 2010 and 2009, respectively)	14	35
Net income	$ 782	$ 8,058
Basic earnings per share:		
Income from continuing operations	$ 0.03	$ 0.27
Income from discontinued operations		
Net income per share, basic	$ 0.03	$ 0.27

Diluted earnings per share:				
Income from continuing operations	$	0.03	$	0.27
Income from discontinued operations				
Net income per share, diluted	$	0.03	$	0.27

See Notes to Consolidated Condensed Financial Statements.

Table of Contents

HEALTHMARKETS, INC.
and Subsidiaries
CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)
(Unaudited)

	Three Months Ended March 31,	
	2010	**2009**
Net income	$ 782	$ 8,058
Other comprehensive income:		
Unrealized gains on securities available for sale arising during the period	11,331	5,101
Reclassification for investment gains included in net income	(219)	(5)
Other-than-temporary impairment losses recognized in OCI		
Effect on other comprehensive income from investment securities	11,112	5,096
Unrealized losses on derivatives used in cash flow hedging during the period	(487)	(490)
Reclassification adjustments included in net income	2,504	2,632
Effect on other comprehensive income from hedging activities	2,017	2,142
Other comprehensive income before tax	13,129	7,238
Income tax expense related to items of other comprehensive income	4,596	2,534
Other comprehensive income net of tax	8,533	4,704
Comprehensive income	$ 9,315	$ 12,762

See Notes to Consolidated Condensed Financial Statements.

Table of Contents

HEALTHMARKETS, INC.
and Subsidiaries
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Operating Activities:		
Net income	$ 782	$ 8,058
Adjustments to reconcile net income to cash (used in) provided by operating activities:		
Income from discontinued operations	(14)	(35)
Realized gains, net	(219)	1,373
Change in deferred income taxes	224	4,139
Depreciation and amortization	5,862	7,162
Amortization of prepaid monitoring fees	3,750	3,125
Equity based compensation expense	1,360	464
Other items, net	4,446	5,161
Changes in assets and liabilities:		
Investment income due and accrued	(2,661)	(338)
Due premiums	1,112	713
Reinsurance recoverable ceded policy liabilities	1,440	12,768
Agent and other receivables	606	1,433
Deferred acquisition costs	8,841	(2,760)
Prepaid monitoring fees	(12,500)	(12,500)
Current income tax recoverable	3,196	(116)
Policy liabilities	(21,154)	(28,558)
Other liabilities and accrued expenses	(13,907)	(20,064)
Cash used in continuing operations	(18,836)	(19,975)
Cash used in discontinued operations	(116)	(59)
Net cash used in operating activities	(18,952)	(20,034)
Investing Activities:		
Student loan receivables	2,193	2,313
Securities available for sale	29,611	9,142
Short-term and other investments, net	109,649	(78,384)
Purchases of property and equipment	(3,627)	(1,481)
Change in restricted cash	2,244	53
Decrease (increase) in agent receivables	459	(2,822)
Cash (used in) provided by continuing operations	140,529	(71,179)
Cash (used in) provided by discontinued operations		
Net cash (used in) provided by investing activities	140,529	(71,179)

Financing Activities:				
Repayment of student loan credit facility		(2,450)		(2,300)
Decrease in investment products		(3,408)		(3,601)
Increase in cash overdraft		3,898		2,236
Proceeds from shares issued to agent plans and other		1,521		2,199
Purchases of treasury stock		(1,764)		(7,660)
Dividends paid		(120,652)		
Excess tax reduction from equity based compensation		(339)		
Cash used in continuing operations		(123,194)		(9,126)
Cash (used in) provided by discontinued operations				
Net cash used in financing activities		(123,194)		(9,126)
Net change in cash and cash equivalents		(1,617)		(100,339)
Cash and cash equivalents at beginning of period		17,406		100,339
Cash and cash equivalents at end of period in continuing operations	$	15,789	$	
Supplemental disclosures:				
Income taxes paid	$		$	
Interest paid	$	2,817	$	7,182

See Notes to Consolidated Condensed Financial Statements.

Table of Contents

HEALTHMARKETS, INC.
and Subsidiaries
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying consolidated condensed financial statements for HealthMarkets, Inc. (the Company or HealthMarkets) and its subsidiaries have been prepared in accordance with United States generally accepted accounting principles (GAAP) for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, such financial statements do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, these financial statements include all adjustments, consisting of normal recurring adjustments and accruals, necessary for the fair presentation of the consolidated condensed balance sheets, statements of income, statements of comprehensive income and statements of cash flows for the periods presented. The accompanying December 31, 2009 consolidated condensed balance sheet was derived from audited consolidated financial statements, but does not include all disclosures required by GAAP for annual financial statement purposes. Preparing financial statements requires management to make estimates and assumptions that affect the amounts that are reported in the financial statements and the accompanying disclosures. Although these estimates are based on management s knowledge of current events and actions that HealthMarkets may undertake in the future, actual results may differ materially from the estimates. Operating results for the three months ended March 31, 2010 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2010. We have evaluated subsequent events for recognition or disclosure through the date we filed this Form 10-Q with the Securities and Exchange Commission (the SEC). For further information, refer to the consolidated financial statements and notes thereto, included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

Concentrations

Through its Commercial Health Division (formerly the Self-Employed Agency Division), the Company s insurance subsidiaries provide health insurance products in 41 states and the District of Columbia. As is the case with many of HealthMarkets competitors in this market, a substantial portion of the Company s insurance subsidiaries products are issued to members of various independent membership associations that act as the master policyholder for such products. In 2010, the two principal membership associations in the self-employed market through which the Company s health insurance products were made available were the Alliance for Affordable Services (AAS) and Americans for Financial Security (AFS). While the Company believes that its insurance subsidiaries are providing association group coverage in full compliance with applicable law, changes in the relationship with the membership associations and/or changes in the laws and regulations governing association group insurance could have a material adverse impact on the Company s financial condition and results of operations. During the three months ended March 31, 2010, the Company issued approximately 48% and 16% of its new policies through AAS and AFS, respectively.

Additionally, during the three months ended March 31, 2010, the Company generated approximately 55% of its health premium revenue from new and existing business from the following 10 states:

	Percentage
California	14%
Texas	7%
Florida	6%
Massachusetts	6%
Illinois	5%
Washington	4%
North Carolina	4%
Maine	3%
Pennsylvania	3%

Wisconsin	3%
	55%

2010 Change in Estimate — Amortization of Intangible Assets

On January 1, 2010, the Company re-evaluated the amortization period related to an intangible asset recorded in both the Commercial Health Division and Insphere Insurance Solutions, Inc (Insphere). See Note 5 of Notes to Consolidated Condensed Financial Statements.

Reclassification

Certain amounts in the 2009 financial statements have been reclassified to conform to the 2010 financial statement presentation.

Student Loans

In connection with the Company s exit from the Life Insurance Division business, HealthMarkets, LLC entered into a definitive Stock Purchase Agreement (as amended, the Stock Purchase Agreement) pursuant to which Wilton Reassurance Company or its affiliates (Wilton) agreed to purchase the Company s student loan funding vehicles, CFLD-I, Inc. (CFLD-I) and UICI Funding Corp. 2 (UFC2), and the related student association. In the Company s Quarterly Report on Form 10-Q for the three months ended March 31, 2009, the assets and liabilities of CFLD-I and UFC2 were presented as Held for sale on the consolidated condensed balance sheets and the results of operations of CFLD-I and UFC2 were included in Income from discontinued operations on the consolidated condensed statements of income. As the Stock Purchase Agreement was terminated in 2009 and the closing of this transaction did not occur, the Company reclassified the assets and liabilities and the results of operations of CFLD-I and UFC2 into continuing operations for all periods presented. Such reclassification resulted in increased income in Income from continuing operations of $36,000 for the three months ended March 31, 2009.

In accordance with the terms of the Coinsurance Agreements, Wilton will fund student loans; provided, however, that Wilton will not be required to fund any student loan that would cause the aggregate par value of all such loans funded by Wilton, following the Coinsurance Effective Date, to exceed $10.0 million. As of March 31, 2010, approximately $1.9 million of student loans have been funded under this agreement, for which the Company has received reimbursements of approximately $1.8 million.

Recent Accounting Pronouncements

On January 1, 2010, the Company adopted Accounting Standards Update (ASU) No. 2009-17, *Consolidations: Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (ASU 2009-17), which provides amendments to Financial Account Standards Board (FASB) Accounting Standards Codification (ASC) Topic 810, *Consolidation*. ASU 2009-17 modifies financial reporting for variable interest entities (VIEs). Under this guidance, companies are required to perform a periodic analysis to determine whether their variable interest must be consolidated by the Company. Additionally, Companies must disclose significant judgments and assumptions made when determining whether it must consolidate a VIE. Upon adoption, the Company determined that Grapevine Finance, LLC (Grapevine) is a VIE and, as such, the Company began consolidating the activities of Grapevine on January 1, 2010. See Note 4 of Notes to Consolidated Condensed Financial Statements.

On January 1, 2010, the Company adopted ASU No. 2009-16, *Accounting for Transfers of Financial Assets and Servicing Assets and Liabilities* (ASU 2009-16), which provides amendments to FASB ASC Topic 860, *Transfers and Servicing* (ASC 860). ASU 2009-16 incorporates the amendments to SFAS No. 140 made by SFAS No. 166, *Accounting for Transfers of Financial Assets an amendment of SFAS No. 140,* into the FASB ASC. ASU 2009-16 provides greater transparency about transfers of financial assets and requires that all servicing assets and servicing liabilities be initially measured at fair value. Additionally, ASU 2009-16 eliminates the concept of a non-consolidated qualifying special-purpose entity (QSPE) and removes the exception from applying FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities,* to QSPEs. Upon adoption, the Company was no longer permitted to account for Grapevine as a QSPE, and instead was required to evaluate its activities under ASU 2009-17. See Note 4 of Notes to Consolidated Condensed Financial Statements.

During the first quarter of 2010, the Company adopted ASC Update 2009-12, *Fair Value Measurements and Disclosures Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent)* (ASC 2009-12), which provides amendments to Subtopic 820, *Fair Value Measurements and Disclosures* (ASC 820), for the fair value measurement of investments in certain entities that calculate net asset value per share (or its equivalent). See Note 2 of Notes to Consolidated Condensed Financial Statements for additional disclosures required under ASC 2009-12.

During the first quarter of 2010, the Company adopted ASC Update 2010-06, *Fair Value Measurements and Disclosures: Improving Disclosures about Fair Value Measurements (ASU 2010-06).* ASU 2010-06 amends ASC Subtopic 820-10 to require new disclosures around the transfers in and out of Level 1 and Level 2 and around activity in Level 3 fair value measurements. Such guidance also provides amendments to ASC 820 which clarifies existing disclosures on the level of disaggregation, inputs and valuation techniques. See Note 2 of Notes to Consolidated Condensed Financial Statements for additional fair value measurement disclosures.

Table of Contents

In January 2010, the FASB issued ASC Update 2010-09, *Subsequent Events: Amendments to Certain Recognition and Disclosure Requirements (ASU 2010-09),* which amends ASC Topic 855, *Subsequent Events*. Such guidance requires an entity to evaluate subsequent events through the date that the financial statements are issued. ASU 2010-09 is effective for interim and annual periods ending after June 15, 2010. The Company had previously evaluated subsequent events through the date the financial statements are issued and will continue to do so under this guidance.

2. FAIR VALUE MEASUREMENTS

In accordance with ASC 820, the Company categorizes its investments and certain other assets and liabilities recorded at fair value into a three-level fair value hierarchy as follows:

Level 1 Unadjusted quoted market prices for identical assets or liabilities in active markets which are accessible by the Company.

Level 2 Observable prices in active markets for similar assets or liabilities. Prices for identical or similar assets or liabilities in markets that are not active. Directly observable market inputs for substantially the full term of the asset or liability, such as interest rates and yield curves at commonly quoted intervals, volatilities, prepayment speeds, default rates, and credit spreads. Market inputs that are not directly observable but are derived from or corroborated by observable market data.

Level 3 Unobservable inputs based on the Company s own judgment as to assumptions a market participant would use, including inputs derived from extrapolation and interpolation that are not corroborated by observable market data.

The Company evaluates the various types of securities in its investment portfolio to determine the appropriate level in the fair value hierarchy based upon trading activity and the observability of market inputs. The Company employs control processes to validate the reasonableness of the fair value estimates of its assets and liabilities, including those estimates based on prices and quotes obtained from independent third party sources. The Company s procedures generally include, but are not limited to, initial and ongoing evaluation of methodologies used by independent third parties and monthly analytical reviews of the prices against current pricing trends and statistics.

Where possible, the Company utilizes quoted market prices to measure fair value. For investments that have quoted market prices in active markets, the Company uses the quoted market price as fair value and includes these prices in the amounts disclosed in Level 1 of the hierarchy. When quoted market prices in active markets are unavailable, the Company determines fair values using various valuation techniques and models based on a range of observable market inputs including pricing models, quoted market price of publicly traded securities with similar duration and yield, time value, yield curve, prepayment speeds, default rates and discounted cash flow. In most cases, these estimates are determined based on independent third party valuation information, and the amounts are disclosed in Level 2 of the fair value hierarchy. Generally, the Company obtains a single price or quote per instrument from independent third parties to assist in establishing the fair value of these investments.

If quoted market prices and independent third party valuation information are unavailable, the Company produces an estimate of fair value based on internally developed valuation techniques, which, depending on the level of observable market inputs, will render the fair value estimate as Level 2 or Level 3. On occasions when pricing service data is unavailable, the Company may rely on bid/ask spreads from dealers in determining the fair value. When dealer quotations are used to assist in establishing the fair value, the Company generally obtains one quote per instrument. The quotes obtained from dealers or brokers are generally non-binding. When dealer quotations are used, the Company uses the mid-mark as fair value. When broker or dealer quotations are used for valuation or price verification, greater priority is given to executable quotes. As part of the price verification process, valuations based on quotes are corroborated by comparison both to other quotes and to recent trading activity in the same or similar instruments.

To the extent the Company determines that a price or quote is inconsistent with actual trading activity observed in that investment or similar investments, or if the Company does not think the quote is reflective of the market value for the investment, the Company will internally develop a fair value using this observable market information and disclose

the occurrence of this circumstance.
In accordance with ASC 820, the Company has categorized its available for sale securities into a three level fair value hierarchy based on the priority of inputs to the valuation techniques. The fair values of investments disclosed in Level 1 of the fair value hierarchy include money market funds and certain U.S. government securities, while the investments disclosed in Level 2 include the majority of the Company s fixed income investments. In cases where there is limited activity or less transparency around inputs to the valuation, the Company classifies the fair value estimates within Level 3 of the fair value hierarchy.

Table of Contents

As of March 31, 2010, all of the Company s investments classified within Level 2 and Level 3 of the fair value hierarchy are valued based on quotes or prices obtained from independent third parties, except for $184.9 million of Corporate debt and other classified as Level 2, $2.0 million of Collateralized debt obligations classified as Level 3 and $1.2 million of Commercial-backed investments classified as Level 3. The $184.9 million of Corporate debt and other investments classified as Level 2 noted above includes $95.8 million of an investment grade corporate bond issued by UnitedHealth Group Inc. that was received as consideration for the sale of the Company s former Student Insurance Division in December 2006 and $80.5 million of an investment grade corporate bond received from a unit of the CIGNA Corporation as consideration for the receipt of the former Star HRG assets (see Note 4 of Notes to Consolidated Condensed Financial Statements).

Fair Value Hierarchy on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis are categorized in the tables below based upon the lowest level of significant input to the valuations.

	Assets at Fair Value at March 31, 2010			
	Level 1	Level 2	Level 3	Total
	(In thousands)			
U.S. and U.S. Government agencies	$ 4,551	$ 37,789	$	$ 42,340
Corporate debt and other		416,964		416,964
Collateralized debt obligations			2,603	2,603
Residential-backed issued by agencies		100,081		100,081
Commercial-backed issued by agencies		8,733		8,733
Residential-backed		3,475		3,475
Commercial-backed		45,328	1,216	46,544
Asset-backed		10,290		10,290
Municipals		171,358	6,676	178,034
Trading securities			9,903	9,903
Put options (1)			647	647
Other invested assets (2)			1,445	1,445
Short-term investments (3)	239,941			239,941
	$ 244,492	$ 794,018	$ 22,490	$ 1,061,000