HealthMarkets, Inc.
Form 10-Q
November 10, 2011

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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 September 30, 2011

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 þ 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ 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 October 21, 2011, the registrant had 28,165,183 outstanding shares of Class A-1 Common Stock, $.01 Par Value, and 2,823,157 outstanding shares of Class A-2 Common Stock, $.01 Par Value.

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

	September 30, 2011 (Unaudited)	December 31, 2010
ASSETS		
Investments:		
Securities available for sale		
Fixed maturities, at fair value (cost: 2011 $408,533; 2010 $644,661)	$ 442,975	$ 679,405
Short-term and other investments	613,513	373,023
Total investments	1,056,488	1,052,428
Cash and cash equivalents	15,060	12,874
Student loan receivables	52,906	60,312
Restricted cash	11,346	13,170
Investment income due and accrued	7,179	7,139
Reinsurance recoverable ceded policy liabilities	359,807	363,243
Agent and other receivables	25,236	32,508
Deferred acquisition costs	20,076	32,689
Property and equipment, net of accumulated depreciation of $154,599 and $147,493 at September 30, 2011 and December 31, 2010, respectively	39,332	41,039
Goodwill	40,384	40,384
Other intangible assets	40,351	41,947
Recoverable federal income taxes		3,443
Other assets	13,957	15,776
Assets held for sale	2,100	2,699
	$ 1,684,222	$ 1,719,651
LIABILITIES AND STOCKHOLDERS EQUITY		
Policy liabilities:		
Future policy and contract benefits	$ 476,545	$ 453,773
Claims	96,638	208,675
Unearned premiums	29,957	34,862
Other policy liabilities	30,853	7,687
Accounts payable and accrued expenses	34,357	38,131
Other liabilities	49,411	58,868
Current federal income taxes	2,994	
Deferred federal income taxes	70,555	58,883
Debt	553,420	553,420
Student loan credit facility	61,750	68,650
Net liabilities of discontinued operations	1,517	1,574
	1,407,997	1,484,523
Commitments and Contingencies (Note 11)		

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, 28,276,279 issued and 28,169,475 outstanding at September 30, 2011; 28,281,859 issued and 28,256,028 outstanding at December 31, 2010. Class A-2, par value $0.01 per share authorized 20,000,000 shares, 4,026,104 issued and 2,882,616 outstanding at September 30, 2011; 4,026,104 issued and 2,762,100 outstanding at December 31, 2010	323	323
Additional paid-in capital	50,207	54,772
Accumulated other comprehensive income	22,731	21,981
Retained earnings	216,402	178,313
Treasury stock, at cost (106,804 Class A-1 common shares and 1,143,488 Class A-2 common shares at September 30, 2011; 25,831 Class A-1 common shares and 1,264,004 Class A-2 common shares at December 31, 2010)	(13,438)	(20,261)
	276,225	235,128
	$ 1,684,222	$ 1,719,651

See Notes to Consolidated Condensed Financial Statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
REVENUE				
Health premiums	$ 131,702	$ 176,736	$ 416,146	$ 571,423
Life premiums and other considerations	357	380	1,213	1,529
	132,059	177,116	417,359	572,952
Investment income	6,154	9,729	22,358	31,840
Commissions and other income	20,561	18,838	62,195	49,377
Net impairment losses recognized in earnings		(765)		(765)
Realized gains, net	2,546	1,225	8,976	3,866
	161,320	206,143	510,888	657,270
BENEFITS AND EXPENSES				
Benefits, claims, and settlement expenses	83,349	57,605	279,036	279,353
Underwriting, acquisition, and insurance expenses	22,399	39,887	78,053	137,185
Other expenses	40,517	67,082	119,856	163,194
Interest expense	4,745	7,375	17,290	22,835
	151,010	171,949	494,235	602,567
Income from continuing operations before income taxes	10,310	34,194	16,653	54,703
Federal income tax expense	3,861	11,951	6,423	21,288
Income from continuing operations	6,449	22,243	10,230	33,415
Income from discontinued operations, (net of income tax expense of $6 and $19 for the three and nine months ended September 30, 2011, and $6 and $21 for the three and nine months ended September 30, 2010, respectively)	11	12	35	39
Net income	$ 6,460	$ 22,255	$ 10,265	$ 33,454
Basic earnings per share:				
Income from continuing operations	$ 0.21	$ 0.75	$ 0.34	$ 1.13
Income from discontinued operations	0.00	0.00	0.00	0.00
Net income per share, basic	$ 0.21	$ 0.75	$ 0.34	$ 1.13

Diluted earnings per share:				
Income from continuing operations	$ 0.21	$ 0.73	$ 0.33	$ 1.09
Income from discontinued operations	0.00	0.00	0.00	0.00
Net income per share, diluted	$ 0.21	$ 0.73	$ 0.33	$ 1.09

See Notes to Consolidated Condensed Financial Statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net income	$ 6,460	$ 22,255	$ 10,265	$ 33,454
Other comprehensive income (loss):				
Unrealized gains on securities available for sale arising during the period	6,555	14,483	8,867	43,352
Reclassification for investment gains included in net income	(2,623)	(1,225)	(9,053)	(3,866)
Other-than-temporary impairment losses recognized in OCI				
Effect on other comprehensive income (loss) from investment securities	3,932	13,258	(186)	39,486
Unrealized gains (losses) on derivatives used in cash flow hedging during the period		(217)	(4)	(683)
Reclassification adjustments included in net income		1,217	1,344	5,190
Effect on other comprehensive income from hedging activities		1,000	1,340	4,507
Other comprehensive income before tax	3,932	14,258	1,154	43,993
Income tax expense (benefit) related to items of other comprehensive income	1,376	4,990	404	15,398
Other comprehensive income (loss) net of tax	2,556	9,268	750	28,595
Comprehensive income	$ 9,016	$ 31,523	$ 11,015	$ 62,049

See Notes to Consolidated Condensed Financial Statements.

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

	Nine Months Ended September 30,	
	2011	**2010**
Operating Activities:		
Net income	$ 10,265	$ 33,454
Adjustments to reconcile net income to cash (used in) provided by operating activities:		
Income from discontinued operations	(35)	(39)
Realized gains, net	(9,054)	(3,101)
Change in deferred income taxes	(3,715)	(7,087)
Depreciation and amortization	13,392	17,096
Amortization of prepaid monitoring fees	9,375	11,250
Equity based compensation expense	4,347	10,642
Other items, net	2,997	9,891
Changes in assets and liabilities:		
Investment income due and accrued	(1,002)	(2,212)
Due premiums	3	928
Reinsurance recoverable ceded policy liabilities	3,436	(421)
Other receivables	10,333	1,553
Deferred acquisition costs	12,613	24,946
Prepaid monitoring fees	(12,500)	(15,000)
Current income tax recoverable	6,437	22,642
Policy liabilities	(27,133)	(121,001)
Other liabilities and accrued expenses	(15,129)	(18,327)
Cash provided by/(used in) continuing operations	4,630	(34,786)
Cash provided by/(used in) discontinued operations	(22)	12
Net cash provided by/(used in) operating activities	4,608	(34,774)
Investing Activities:		
Student loan receivables	6,123	6,565
Securities available for sale	244,215	120,863
Short-term and other investments, net	(240,916)	54,715
Purchases of property and equipment	(6,531)	(8,459)
Intangible assets acquired		(297)
Acquisitions net of cash acquired		252
Change in restricted cash	1,824	1,742
Increase in agent receivables	(286)	(6,421)
Cash provided by continuing operations	4,429	168,960
Cash provided by discontinued operations		

Net cash provided by investing activities	4,429	168,960
Financing Activities:		
Repayment of student loan credit facility	(6,900)	(6,950)
Decrease in investment products	(1,064)	(4,144)
Change in cash overdraft	5,310	(7,055)
Proceeds from shares issued to agent plans and other	3,210	6,099
Purchases of treasury stock	(6,614)	(8,675)
Dividends paid		(119,514)
Excess tax reduction from equity based compensation	(793)	(1,287)
Cash used in continuing operations	(6,851)	(141,526)
Cash used in discontinued operations		
Net cash used in financing activities	(6,851)	(141,526)
Net change in cash and cash equivalents	2,186	(7,340)
Cash and cash equivalents at beginning of period	12,874	17,406
Cash and cash equivalents at end of period in continuing operations	$ 15,060	$ 10,066
Supplemental disclosures:		
Income taxes paid	$ 6,643	$ 9,168
Interest paid	$ 10,375	$ 20,823

See Notes to Consolidated Condensed Financial Statements.

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HEALTHMARKETS, INC.
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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, 2010 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 and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2011. 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, 2010.

HealthMarkets, Inc. is a holding company, the principal asset of which is its investment in its wholly owned subsidiary, HealthMarkets, LLC. HealthMarkets, LLC s principal assets are its investments in its separate operating subsidiaries, including its regulated insurance subsidiaries. HealthMarkets conducts its insurance underwriting businesses through its indirect wholly owned insurance company subsidiaries, The MEGA Life and Health Insurance Company (MEGA), Mid-West National Life Insurance Company of Tennessee (Mid-West) and The Chesapeake Life Insurance Company (Chesapeake), and conducts its insurance distribution business through its indirect insurance agency subsidiary, Insphere Insurance Solutions, Inc. (Insphere).

Reclassification

Certain amounts in the 2010 financial statements have been reclassified to conform to the 2011 financial statement presentation.

2. CHANGE IN ACCOUNTING PRINCIPLE

Effective January 1, 2011, the Company changed the method used to calculate its policy liabilities for the majority of its health insurance products because it believes that the new method will be preferable in light of, among other factors, certain changes required by Health Care Reform Legislation.

For the majority of health insurance products in the Commercial Health Division, the Company s claims liabilities are estimated using the developmental method. The Company establishes the claims liabilities based upon claim incurral dates, supplemented with certain refinements as appropriate. Prior to January 1, 2011, for products introduced prior to 2008, the Company used a technique for calculating claims liabilities referred to as the Modified Incurred Date (MID) technique. Under the MID technique, claims liabilities for the cost of all medical services related to a distinct accident or sickness are based on the earliest date of diagnosis or treatment, even though the medical services associated with such accident or sickness might not be rendered to the insured until a later financial reporting period. Claims liabilities based on the earliest date of diagnosis generally result in larger initial claims liabilities which complete over a longer period of time than claims estimation techniques using dates of service. Under the MID technique, the Company modifies the original incurred date coding by establishing a new incurral date if: (i) there is a break of more than six months in the occurrence of a covered benefit service or (ii) if claims payments continue for more than thirty-six months without a six month break in service.

For products introduced in 2008 and later, claims payments are considered incurred on the date the service is rendered, regardless of whether the sickness or accident is distinct or the same. This is referred to as the Service Date

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(SD) technique. This is consistent with the assumptions used in the pricing of these products and the policy language. At December 31, 2010, the Company had claims liabilities for products using the SD technique in the amount of $10.6 million, representing approximately 8% of the total claims liabilities of the Commercial Health Division. The use of the SD technique in establishing claims liabilities requires the establishment of a future policy benefit reserve while the MID technique does not. For the reasons discussed below, we believe that it is preferable to estimate the Company s claims liabilities using the SD technique, and to apply such technique for claims liabilities previously calculated based on the MID technique.

As previously disclosed, in March 2010, Health Care Reform Legislation was signed into law. The Health Care Reform Legislation requires, beginning in 2011, a mandated minimum loss ratio (MLR) of 80% for the individual and small group markets. If MLR is below the mandated minimum, the Health Care Reform Legislation generally requires that the insurer return the amount of premium that is in excess of the required MLR to the policyholder in the form of rebates. The MLR is calculated for each of our insurance subsidiaries on a state-by-state basis in each state where the Company has issued major medical business. The Interim Final Rule from the Department of Health and Human Services (HHS) indicates that the MLR calculation shall utilize data on incurred claims for the calendar year, paid through March of the following year.

Any refund of premiums in excess of the required MLR will be based on the completion of claims three months after the calendar year end. Based on the MLR calculation requiring only three additional months of claims and the SD technique being the most prevalent method of estimating claims liabilities in the health insurance industry, the Company believes that the SD technique is the preferable method for calculating the MLR. The Company also believes that using the SD method for the settlement of the MLR calculation will reduce uncertainty regarding the ultimate amount of incurred claims, as the MID technique estimates claims over a longer settlement period. The calculation of the MLR using the Company s current data results in claims for a given incurred year that are approximately 95% complete three months after the valuation date using the SD technique, whereas claims are approximately 82% complete 3 months after the valuation date using the MID technique. Additionally, the use of the MID technique for financial reporting purposes, with the settlement of the MLR calculated on a SD basis, may result in an over accrual of the claims liabilities on the financial statements as a result of the Company s accrual for rebates in the MLR calculation.

In light of the changes resulting from the Health Care Reform Legislation, and given that the Company s insurance contracts would support the use of either reserving technique, the Company, after discussions with its domiciliary insurance regulators on the preferred methodology for calculating rebates under the MLR requirements of the Health Care Reform Legislation, determined that the SD method is preferable in determining the estimation of its claims liabilities. For the in-force policies utilizing the MID technique for estimation of claims liabilities, effective January 1, 2011, the Company changed the method used to calculate its claims liabilities from the MID technique to the SD technique. Consistent with the Company s products introduced in 2008 and later, the Company established a reserve for future policy benefits for products introduced prior to 2008.

The Company has determined it is impracticable to determine the period-specific effects of the change in reserving methodology from MID to SD on all prior periods since retrospective application requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates at previous reporting dates. Based on the guidance of *ASC 250-10-45 Accounting Changes Change in Accounting Principle* if the cumulative effect of applying a change in accounting principle to all prior periods is determinable, but it is impracticable to determine the period-specific effects of that change to all prior periods presented, the cumulative effect of the change to the new accounting principle shall be applied to the carrying amounts of assets and liabilities as of beginning of the earliest period to which the new accounting principle can be applied. As such the Company accounted for the change effective January 1, 2011 by recording the cumulative effect of the change in accounting at that date.

Effective January 1, 2011, as a result of this change, the Company recorded the following: (i) a decrease in the amount of $77.9 million to claims and claims administration liabilities, (ii) an increase in the amount of $35.1 million to future policy and contract benefits, (iii) an increase in the amount of $15.0 million to deferred federal income tax liability and (iv) an increase in the amount of $27.8 million to retained earnings.

3. CONCENTRATIONS

Insphere maintains marketing agreements for the distribution of health benefits plans with a number of non-affiliated insurance carriers as well as the Company s own insurance subsidiaries. The non-affiliated carriers include, among others, United Healthcare s Golden Rule Insurance Company, Humana and Aetna, for which Insphere distributes individual health insurance products. The products offered by these third-party carriers and the Company s insurance subsidiaries offer

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coverage and benefit variations that may fit one consumer better than another. In the markets where Insphere has commenced distribution of these third-party carrier products, these products have, to a great extent, replaced the sale of the Company s own health benefit plans. During the nine months ended September 30, 2011, approximately 78% of health benefit plan sales marketed by Insphere were underwritten by these three third-party carriers.

Additionally, during the nine months ended September 30, 2011, the Company s insurance subsidiaries generated approximately 57% of premium revenue from new and existing business from the following 10 states:

	Percentage
California	14%
Texas	7%
Maine	7%
Florida	6%
Washington	5%
Massachusetts	5%
Illinois	4%
North Carolina	3%
Pennsylvania	3%
Georgia	3%
	57%

4. RECENT ACCOUNTING PRONOUNCEMENTS

In October 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2010-26, *Financial Services Insurance (ASC Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* (ASU 2010-26), which clarifies what costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. Costs that should be capitalized include (1) incremental direct costs of successful contract acquisition and (2) certain costs related directly to successful acquisition activities (underwriting, policy issuance and processing, medical and inspection, and sales force contract selling) performed by the insurer for the contract. Advertising costs should be included in deferred acquisition costs only if the capitalization criteria in the U.S. GAAP direct-response advertising guidance are met. All other acquisition-related costs should be charged to expense as incurred. The provisions of ASU 2010-26 are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011, and should be applied prospectively. Retrospective application is permitted, and early adoption is permitted at the beginning of an entity s annual reporting period. The Company is currently in the process of determining the impact of adoption of the provisions of ASU 2010-26.

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. Certain disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements are effective for fiscal years beginning after December 15, 2010. The Company implemented these additional disclosure items in the first quarter of 2011.

On May 12, 2011, the International Accounting Standards Board (IASB) and the FASB issued IFRS 13, *Fair Value Measurement*, and FASB ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, respectively, to provide largely identical guidance about fair value measurement and disclosure requirements. Issuing these standards completes a major project of the Boards joint work to improve and converge IFRS and U.S. GAAP. The new standards do not extend the use of fair value but, rather, provide guidance about how fair value should be applied where it already is required or permitted under IFRS or U.S. GAAP. For U.S. GAAP, most of the changes are clarifications of existing guidance or wording changes to align with IFRS 13. A public entity is required to apply the ASU prospectively for interim and annual periods beginning after December 15, 2011. Early adoption is not permitted for a public entity. The Company is currently in the process of

determining the impact of adoption of the provisions of ASU 2011-04.

In June 2011, the FASB issued ASU 2011-05 *Presentation of Comprehensive Income*. This ASU eliminates the option in U.S. GAAP to present other comprehensive income in the statement of changes in equity. For a public entity, the ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. The guidance does not change whether items are reported in net income or other comprehensive income or when items in other comprehensive income are reclassified to net income; accordingly, adoption of ASU 2011-05 will not impact the operating results, financial position or liquidity of the Company.

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In September 2011, the FASB issued ASU 2011-08 *Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. Under the amendments in this update, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is necessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of a repo