

HCC INSURANCE HOLDINGS INC/DE/

Form 10-Q

May 10, 2006

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**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 Quarter Ended March 31, 2006.

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from _____ to _____

Commission file number 001-13790

HCC Insurance Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware

76-0336636

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification

No.)

13403 Northwest Freeway, Houston, Texas

77040-6094

(Address of principal executive offices)

(Zip Code)

(713) 690-7300

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (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

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

Yes No

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date.

On April 30, 2006, there were approximately 111.2 million shares of common stock, \$1.00 par value issued and outstanding.

**HCC INSURANCE HOLDINGS, INC.
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| <u>Certification with Respect to Quarterly Report</u> | |
| <p><i>This report on Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created by those laws. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as future capital expenditures, business strategy, competitive strengths, goals, growth of our business and operations, plans and references to future successes may be considered forward-looking statements. Also, when we use words such as anticipate, believe, estimate, expect, intend, plan, probably or similar expressions, we are making forward-looking statements.</i></p> <p><i>Many risks and uncertainties may impact the matters addressed in these forward-looking statements, which could affect our future financial results and performance, including, among other things:</i></p> <ul style="list-style-type: none"> <i>the effects of catastrophic losses;</i> <i>the cyclical nature of the insurance business;</i> <i>inherent uncertainties in the loss estimation process, which can adversely impact the adequacy of loss reserves;</i> <i>the effects of emerging claim and coverage issues;</i> <i>the effects of extensive governmental regulation of the insurance industry;</i> <i>potential credit risk with brokers;</i> | |

our increased retention of risk, which could expose us to greater potential losses;

the adequacy of reinsurance protection;

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the ability or willingness of reinsurers to pay balances due us;

the occurrence of terrorist activities;

our ability to maintain our competitive position;

changes in our assigned financial strength ratings;

our ability to raise capital in the future;

attraction and retention of qualified employees;

fluctuations in the fixed income securities market, which may reduce the value of our investment assets;

our ability to successfully expand our business through the acquisition of insurance-related companies;

our ability to receive dividends from our insurance company subsidiaries in needed amounts;

fluctuations in foreign exchange rates; and

failures of our information technology systems, which could adversely affect our business.

These events or factors could cause our results or performance to differ materially from those we express in our forward-looking statements. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of these assumptions, and, therefore, also the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements which are included in this report, our inclusion of this information is not a representation by us or any other person that our objectives and plans will be achieved.

Our forward-looking statements speak only at the date made and we will not update these forward-looking statements unless the securities laws require us to do so. In light of these risks, uncertainties and assumptions, any forward-looking events discussed in this report may not occur.

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HCC Insurance Holdings, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(unaudited, in thousands, except per share data)

| | March 31, 2006 | December 31, 2005 |
|---|---------------------|----------------------|
| ASSETS | | |
| Investments: | | |
| Fixed income securities, at fair value (amortized cost: 2006 - \$2,573,727; 2005 - \$2,277,139) | \$ 2,541,316 | \$ 2,268,624 |
| Short-term investments, at cost, which approximates fair value | 592,831 | 839,581 |
| Other investments, at fair value (cost: 2006 - \$216,020; 2005 - \$144,897) | 230,187 | 149,223 |
| | | |
| Total investments | 3,364,334 | 3,257,428 |
| Cash | 51,111 | 73,935 |
| Restricted cash and cash investments | 182,568 | 170,978 |
| Premium, claims and other receivables | 855,880 | 884,654 |
| Reinsurance recoverables | 1,349,351 | 1,360,483 |
| Ceded unearned premium | 239,530 | 239,416 |
| Ceded life and annuity benefits | 73,213 | 73,415 |
| Deferred policy acquisition costs | 161,329 | 156,253 |
| Goodwill | 531,286 | 532,947 |
| Other assets | 297,716 | 276,557 |
| | | |
| Total assets | \$ 7,106,318 | \$ 7,026,066 |
| | | |
| LIABILITIES | | |
| Loss and loss adjustment expense payable | \$ 2,837,495 | \$ 2,813,720 |
| Life and annuity policy benefits | 73,213 | 73,415 |
| Reinsurance balances payable | 149,897 | 176,954 |
| Unearned premium | 825,375 | 807,109 |
| Deferred ceding commissions | 66,900 | 65,702 |
| Premium and claims payable | 735,131 | 753,859 |
| Notes payable | 309,426 | 309,543 |
| Accounts payable and accrued liabilities | 350,578 | 332,068 |
| | | |
| Total liabilities | 5,348,015 | 5,332,370 |
| | | |
| SHAREHOLDERS EQUITY | | |
| Common stock, \$1.00 par value; 250.0 million shares authorized (shares issued and outstanding: 2006 111,173; 2005 110,803) | 111,173 | 110,803 |
| Additional paid-in capital | 757,850 | 747,568 |

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| | | |
|--|---------------------|---------------------|
| Retained earnings | 887,226 | 817,013 |
| Accumulated other comprehensive income | 2,054 | 18,312 |
| Total shareholders equity | 1,758,303 | 1,693,696 |
| Total liabilities and shareholders equity | \$ 7,106,318 | \$ 7,026,066 |

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Condensed Consolidated Statements of Earnings
(unaudited, in thousands, except per share data)

| | Three months ended March 31, | |
|---|---------------------------------|------------------|
| | 2006 | 2005 |
| REVENUE | | |
| Net earned premium | \$ 380,571 | \$ 320,117 |
| Fee and commission income | 31,468 | 33,076 |
| Net investment income | 36,581 | 22,341 |
| Net realized investment loss | (1,298) | (3) |
| Other operating income | 18,750 | 4,147 |
| Total revenue | 466,072 | 379,678 |
| EXPENSE | | |
| Loss and loss adjustment expense, net | 220,567 | 186,063 |
| Policy acquisition costs, net | 78,215 | 59,357 |
| Other operating expense | 46,803 | 45,949 |
| Interest expense | 2,154 | 1,808 |
| Total expense | 347,739 | 293,177 |
| Earnings before income tax expense | 118,333 | 86,501 |
| Income tax expense | 39,782 | 29,183 |
| Net earnings | \$ 78,551 | \$ 57,318 |
| Basic earnings per share data: | | |
| Net earnings per share | \$ 0.71 | \$ 0.56 |
| Weighted average shares outstanding | 111,014 | 103,241 |
| Diluted earnings per share data: | | |
| Net earnings per share | \$ 0.67 | \$ 0.54 |

| | | |
|-------------------------------------|---------|---------|
| Weighted average shares outstanding | 116,896 | 105,734 |
|-------------------------------------|---------|---------|

| | | |
|------------------------------------|----------|----------|
| Cash dividends declared, per share | \$ 0.075 | \$ 0.057 |
|------------------------------------|----------|----------|

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
 Condensed Consolidated Statement of Changes in Shareholders' Equity
 Three months ended March 31, 2006
 (unaudited, in thousands, except per share data)

| | Common stock | Additional paid-in capital | Retained earnings | Accumulated other comprehensive income | Total shareholders equity |
|--|-----------------|----------------------------------|----------------------|---|---------------------------------|
| Balance at December 31, 2005 | \$ 110,803 | \$ 747,568 | \$ 817,013 | \$ 18,312 | \$ 1,693,696 |
| Net earnings | | | 78,551 | | 78,551 |
| Other comprehensive loss | | | | (16,258) | (16,258) |
| Comprehensive income | | | | | 62,293 |
| Issuance of 370 shares for exercise of options, including tax benefit of \$1,904 | 370 | 7,422 | | | 7,792 |
| Stock-based compensation | | 2,860 | | | 2,860 |
| Cash dividends declared, \$0.075 per share | | | (8,338) | | (8,338) |
| Balance at March 31, 2006 | \$ 111,173 | \$ 757,850 | \$ 887,226 | \$ 2,054 | \$ 1,758,303 |

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(unaudited, in thousands)

| | Three months ended March 31, | |
|---|------------------------------|-----------------|
| | 2006 | 2005 |
| Cash flows from operating activities: | | |
| Net earnings | \$ 78,551 | \$ 57,318 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Change in premium, claims and other receivables | 44,362 | (133,768) |
| Change in reinsurance recoverables | 11,132 | (824) |
| Change in ceded unearned premium | (114) | 52,300 |
| Change in loss and loss adjustment expense payable | 23,775 | 49,939 |
| Change in reinsurance balances payable | (27,057) | (29,842) |
| Change in unearned premium | 18,266 | (16,842) |
| Change in premium and claims payable, net of restricted cash | (30,318) | 99,875 |
| Change in trading portfolio | (47,994) | (41,328) |
| Depreciation and amortization expense | 3,825 | 3,710 |
| Other, net | 3,509 | (6,629) |
| Cash provided by operating activities | 77,937 | 33,909 |
| Cash flows from investing activities: | | |
| Sales of fixed income securities | 65,654 | 55,681 |
| Maturity or call of fixed income securities | 59,226 | 32,250 |
| Cost of securities acquired | (471,614) | (277,000) |
| Change in short-term investments | 246,750 | 145,025 |
| Sale of strategic investment | 17,363 | |
| Earnout payment for purchase of subsidiary | (24,000) | |
| Other, net | (2,047) | (1,118) |
| Cash used by investing activities | (108,668) | (45,162) |
| Cash flows from financing activities: | | |
| Issuance of notes payable | 11,000 | |
| Payments on notes payable | (11,107) | (93) |
| Sale of common stock | 7,792 | 21,087 |
| Dividends paid | (8,310) | (5,783) |
| Other | 8,532 | (3,814) |
| Cash provided by financing activities | 7,907 | 11,397 |
| Net increase (decrease) in cash | (22,824) | 144 |
| Cash at beginning of period | 73,935 | 69,933 |

| | | |
|------------------------------|-----------|-----------|
| Cash at end of period | \$ 51,111 | \$ 70,077 |
|------------------------------|-----------|-----------|

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited, tables in thousands, except per share data)

(1) GENERAL INFORMATION

HCC Insurance Holdings, Inc. and its subsidiaries (collectively, we, us or our) include domestic and foreign property and casualty and life insurance companies, underwriting agencies and reinsurance brokers. We provide specialized property and casualty, surety, and group life, accident and health insurance coverages and related agency and reinsurance brokerage services to commercial customers and individuals. We market our products both directly to customers and through a network of independent brokers, producers and agents. Our lines of business include diversified financial products (which includes directors and officers liability, professional indemnity, employment practices liability and surety); group life, accident and health; aviation; London market account (which includes energy, marine, property, and accident and health); and other specialty lines of insurance. We operate primarily in the United States, the United Kingdom, Spain, Bermuda and Ireland, although some of our operations have a broader international scope.

Basis of Presentation

Our unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (generally accepted accounting principles) and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. We have made all adjustments that, in our opinion, are necessary for a fair presentation of results of the interim periods, and all such adjustments are of a normal recurring nature. All significant intercompany balances and transactions have been eliminated in consolidation. The condensed consolidated financial statements should be read in conjunction with our annual audited consolidated financial statements and related notes. The condensed consolidated balance sheet at December 31, 2005 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

Management must make estimates and assumptions that affect amounts reported in our financial statements and in disclosures of contingent assets and liabilities. Ultimate results could differ from those estimates. We have reclassified certain amounts in our 2005 condensed consolidated financial statements to conform to the 2006 presentation. The reclassifications included the elimination of certain intercompany premium receivable and premium payable balances and reclassification of the corresponding lines in our 2005 condensed statement of cash flows. None of our reclassifications had an effect on our consolidated net earnings, shareholders' equity or cash flows.

During 2005, we completed several acquisitions. The results of operations of the acquired entities are included in our condensed consolidated financial statements beginning on the effective date of each acquisition. Thus, our condensed consolidated statements of earnings and cash flows for the three months ended March 31, 2005 do not contain any operations of the entities acquired in 2005 prior to their acquisition date.

Income Tax

For the three months ended March 31, 2006 and 2005, the income tax provision was calculated based on an estimated effective tax rate for each fiscal year. Our effective tax rate differs from the United States Federal statutory rate primarily due to tax-exempt municipal bond interest and state income taxes.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited, tables in thousands, except per share data)

(2) STOCK OPTIONS

Our stock option plans, the 2004 Flexible Incentive Plan and 2001 Flexible Incentive Plan, are administered by the Compensation Committee of the Board of Directors. Options granted under these plans may be used to purchase one share of our common stock. All options are granted at fixed exercise prices at the market price of our common stock on the grant date and no options have been repriced. Options vest over a period of up to seven years, which is the requisite service period, and expire four to ten years after grant date.

Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, requires companies to charge the fair value of stock-based compensation to earnings. Effective January 1, 2006, we adopted SFAS 123(R) using the modified prospective method. Compensation expense will be recognized in 2006 and thereafter based on our unvested stock options granted before January 1, 2006 and all options granted after that date. The 2005 and prior period financial statements were not restated. We will use the Black-Scholes single option pricing model to determine the fair value of an option on its grant date and will expense that value on a straight-line basis over the option's vesting period. We made no modifications to our stock option plans in conjunction with our adoption of SFAS 123(R). In 2005, we accounted for stock options granted to employees in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and no stock-based compensation expense was recorded.

In the first quarter of 2006, we expensed \$2.3 million (\$1.7 million after tax or \$0.01 per diluted share) of stock-based compensation, after the effect of the deferral and amortization of related policy acquisition costs. At March 31, 2006, there was approximately \$33.6 million of total unrecognized compensation expense related to unvested options that is expected to be recognized over a weighted-average period of three years. In 2006, we expect to recognize \$10.4 million of expense, including the amortization of deferred policy acquisition costs, related to stock-based compensation for options currently outstanding.

The table below shows the weighted-average fair value of options granted and the related weighted-average assumptions used in the Black-Scholes model. The risk-free interest rate is based on the U.S. Treasury rate that most closely approximates each option's expected term. We based our expected volatility on the historical volatility of our stock over a period matching each option's expected term. Our dividend yield is based on an average of our historical dividend payments divided by the stock price. We used historical exercise patterns by grant type to estimate the expected option life.

| | Three months ended March 31, | |
|-------------------------------|---------------------------------|-----------|
| | 2006 | 2005 |
| Fair value of options granted | \$ 6.65 | \$ 7.09 |
| Risk free interest rate | 4.5% | 3.8% |
| Expected volatility | 22% | 32% |
| Expected dividend yield | 1.0% | 1.0% |
| Expected option life | 3.5 years | 4.9 years |

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited, tables in thousands, except per share data)

The following table details our stock option activity during the three months ended March 31, 2006.

| | Number of shares | Weighted- average exercise price | Weighted- average contractual life | Aggregate intrinsic value |
|-----------------------------------|---------------------|---|---|---------------------------------|
| Outstanding, beginning of year | 8,219 | \$20.71 | | |
| Granted at market value | 463 | 31.64 | | |
| Exercised | (373) | 15.87 | | |
| Forfeited and expired | (106) | 20.58 | | |
| Outstanding, end of period | 8,203 | 21.55 | 4.3 years | \$ 108,701 |
| Exercisable, end of period | 1,660 | 17.36 | 3.0 years | 28,953 |

The aggregate intrinsic value (the amount by which the fair value of the underlying stock exceeds the exercise price) of options exercised during the first quarter of 2006 and 2005 was \$6.0 million and \$13.8 million, respectively. At March 31, 2006, 12.1 million shares of our common stock were authorized and reserved for the exercise of options, of which 8.2 million shares were reserved for options previously granted and 3.9 million shares were reserved for future issuance.

Exercise of options during the first quarter of 2006 and 2005 resulted in cash receipts of \$5.9 million and \$21.1 million, respectively. We generally recognize a tax benefit when our employees exercise options. SFAS 123(R) requires that we report the tax benefit related to the excess of the tax deductible amount over the recognized compensation expense as financing cash flow, rather than as operating cash flow under APB 25. We recorded a \$1.9 million benefit as financing cash flow in the first quarter of 2006 and \$4.9 million as operating cash flow in the first quarter of 2005.

Prior to adoption of SFAS 123(R), we were required to disclose the effect on net earnings and earnings per share if we had used the fair value method of SFAS No. 123, *Accounting for Stock-Based Compensation*, to value stock options. The effect on our consolidated financial results in the first quarter of 2005 if we had valued our options using the fair value method under SFAS 123 and the assumptions listed above for the three months ended March 31, 2005 is as follows:

| | |
|---|-----------|
| Reported net earnings | \$ 57,318 |
| Stock-based compensation using fair value method, net of income taxes | (1,277) |
| Pro forma net earnings | \$ 56,041 |
| Reported basic earnings per share | \$ 0.56 |
| Fair value stock-based compensation | (0.02) |
| Pro forma basic earnings per share | \$ 0.54 |
| Reported diluted earnings per share | \$ 0.54 |
| Fair value stock-based compensation | (0.01) |

Pro forma diluted earnings per share

\$ 0.53

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited, tables in thousands, except per share data)

(3) REINSURANCE

In the normal course of business, our insurance companies cede a portion of their premium to domestic and foreign reinsurers through treaty and facultative reinsurance agreements. Although ceding for reinsurance purposes does not discharge the primary insurer from liability to its policyholder, our insurance companies participate in such agreements in order to limit their loss exposure, protect them against catastrophic loss and diversify their business. The following table presents the effect of such reinsurance transactions on our premium and loss and loss adjustment expense.

| | Written premium | Earned premium | Loss and loss adjustment expense |
|-----------------------------------|--------------------|-------------------|---|
| Three months ended March 31, 2006 | | | |
| Primary business | \$ 410,191 | \$ 422,510 | \$ 227,250 |
| Reinsurance assumed | 95,867 | 70,880 | 45,791 |
| Reinsurance ceded | (113,007) | (112,819) | (52,474) |
| Net amounts | \$ 393,051 | \$ 380,571 | \$ 220,567 |
| Three months ended March 31, 2005 | | | |
| Primary business | \$ 398,281 | \$ 412,095 | \$ 221,534 |
| Reinsurance assumed | 76,838 | 72,580 | 48,506 |
| Reinsurance ceded | (117,767) | (164,558) | (83,977) |
| Net amounts | \$ 357,352 | \$ 320,117 | \$ 186,063 |

Ceding commissions netted with policy acquisition costs in the condensed consolidated statements of earnings were \$10.0 million in 2006 and \$30.7 million in 2005.

The table below shows the components of reinsurance recoverables in our condensed consolidated balance sheets.

| | March 31, 2006 | December 31, 2005 |
|---|---------------------|----------------------|
| Reinsurance recoverable on paid losses | \$ 102,200 | \$ 93,837 |
| Reinsurance recoverable on outstanding losses | 730,451 | 634,725 |
| Reinsurance recoverable on incurred but not reported losses | 527,012 | 644,062 |
| Reserve for uncollectible reinsurance | (10,312) | (12,141) |
| Total reinsurance recoverables | \$ 1,349,351 | \$ 1,360,483 |

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited, tables in thousands, except per share data)

Our reserve for uncollectible reinsurance covers potential collectibility issues, including disputed amounts and associated expenses. While we believe the reserve is adequate based on information currently available, conditions may change or additional information might be obtained which may require us to change the reserve in the future. We periodically review our financial exposure to the reinsurance market and the level of our reserve and continue to take actions in an attempt to mitigate our exposure to possible loss.

We limit the liquidity exposure related to our reinsurance recoverables by holding funds, letters of credit or other security, such that net balances due are significantly less than the gross balances shown in our condensed consolidated balance sheets. Additionally, our U.S. domiciled insurance companies require their reinsurers not authorized by the respective states of domicile of our insurance companies to collateralize their reinsurance obligations due to us. The table below shows the amounts of letters of credit and cash deposits held by us as collateral, plus other credits available for potential offset.

| | March 31, 2006 | December 31, 2005 |
|------------------------|-------------------|-------------------------|
| Payables to reinsurers | \$ 293,480 | \$ 291,826 |
| Letters of credit | 348,292 | 350,135 |
| Cash deposits | 58,025 | 64,150 |
| Total credits | \$ 699,797 | \$ 706,111 |

The tables below present the calculation of net reserves, net unearned premium and net deferred policy acquisition costs.

| | March 31, 2006 | December 31, 2005 |
|---|---------------------|----------------------|
| Loss and loss adjustment expense payable | \$ 2,837,495 | \$ 2,813,720 |
| Reinsurance recoverable on outstanding losses | (730,451) | (634,725) |
| Reinsurance recoverable on incurred but not reported losses | (527,012) | (644,062) |
| Net reserves | \$ 1,580,032 | \$ 1,534,933 |
| Unearned premium | \$ 825,375 | \$ 807,109 |
| Ceded unearned premium | (239,530) | (239,416) |
| Net unearned premium | \$ 585,845 | \$ 567,693 |
| Deferred policy acquisition costs | \$ 161,329 | \$ 156,253 |
| Deferred ceding commissions | (66,900) | (65,702) |

| | | |
|--|-----------|-----------|
| Net deferred policy acquisition costs | \$ 94,429 | \$ 90,551 |
|--|-----------|-----------|

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited, tables in thousands, except per share data)

(4) EARNINGS PER SHARE

The following table details the numerator and denominator used in the earnings per share calculations.

| | Three months ended March | |
|---|--------------------------|----------------|
| | 2006 | 2005 |
| Net earnings | \$ 78,551 | \$ 57,318 |
| Weighted average common shares outstanding | 111,014 | 103,241 |
| Dilutive effect of outstanding options (determined using the treasury stock method) | 1,528 | 1,589 |
| Dilutive effect of convertible debt (determined using the treasury stock method) | 4,354 | 904 |
| Weighted average common shares and potential common shares outstanding | 116,896 | 105,734 |
| Anti-dilutive stock options not included in treasury stock method computation | 2,563 | 26 |

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited, tables in thousands, except per share data)

(5) SEGMENT AND GEOGRAPHIC INFORMATION

The performance of each segment is evaluated by our management based on net earnings. Net earnings is calculated after tax and after all corporate expense allocations, interest expense on debt incurred at the purchase date, and intercompany eliminations have been charged or credited to our individual segments. The following tables show information by business segment and geographic location. Geographic location is determined by physical location of our offices and does not represent the location of insureds or reinsureds from whom the business was generated. Effective January 1, 2005, we consolidated our largest underwriting agency (agency segment) into HCC Life Insurance Company (insurance company segment).

| | Insurance Company | Agency | Other Operations | Corporate | Total |
|--|----------------------|------------------|---------------------|-------------------|-------------------|
| Three months ended March 31, 2006 | | | | | |
| Revenue: | | | | | |
| Domestic | \$ 343,487 | \$ 14,769 | \$ 19,781 | \$ 1,177 | \$ 379,214 |
| Foreign | 76,849 | 10,009 | | | 86,858 |
| Inter-segment | 6 | 17,958 | | | 17,964 |
| Total segment revenue | \$ 420,342 | \$ 42,736 | \$ 19,781 | \$ 1,177 | 484,036 |
| Inter-segment eliminations | | | | | (17,964) |
| Consolidated total revenue | | | | | \$ 466,072 |
| Net earnings (loss): | | | | | |
| Domestic | \$ 49,018 | \$ 4,825 | \$ 12,989 | \$ (1,937) | \$ 64,895 |
| Foreign | 9,801 | 3,569 | | | 13,370 |
| Total segment net earnings (loss) | \$ 58,819 | \$ 8,394 | \$ 12,989 | \$ (1,937) | 78,265 |
| Inter-segment eliminations | | | | | 286 |
| Consolidated net earnings | | | | | \$ 78,551 |
| Other items: | | | | | |
| Net investment income | \$ 32,007 | \$ 2,296 | \$ 1,635 | \$ 643 | \$ 36,581 |
| Depreciation and amortization | 1,138 | 2,013 | 127 | 547 | 3,825 |

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| | | | | | |
|---------------------------------|--------|-------|-------|---------|-----------|
| Interest expense (benefit) | 375 | 2,846 | 114 | (1,181) | 2,154 |
| Capital expenditures | 461 | 815 | 438 | 1,366 | 3,080 |
| Income tax expense (benefit) | 27,430 | 6,383 | 6,141 | (470) | 39,484 |
| Inter-segment eliminations | | | | | 298 |
| Consolidated income tax expense | | | | | \$ 39,782 |

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited, tables in thousands, except per share data)

| | Insurance Company | Agency | Other Operations | Corporate | Total |
|--|----------------------|------------------|---------------------|-------------------|-------------------|
| Three months ended March 31, 2005 | | | | | |
| Revenue: | | | | | |
| Domestic | \$ 284,643 | \$ 12,762 | \$ 1,906 | \$ 579 | \$ 299,890 |
| Foreign | 68,837 | 10,951 | | | 79,788 |
| Inter-segment | 96 | 21,529 | | | 21,625 |
| Total segment revenue | \$ 353,576 | \$ 45,242 | \$ 1,906 | \$ 579 | 401,303 |
| Inter-segment eliminations | | | | | (21,625) |
| Consolidated total revenue | | | | | \$ 379,678 |
| Net earnings (loss): | | | | | |
| Domestic | \$ 36,817 | \$ 7,044 | \$ 1,091 | \$ (3,391) | \$ 41,561 |
| Foreign | 11,647 | 1,973 | | | 13,620 |
| Total segment net earnings (loss) | \$ 48,464 | \$ 9,017 | \$ 1,091 | \$ (3,391) | 55,181 |
| Inter-segment eliminations | | | | | 2,137 |
| Consolidated net earnings | | | | | \$ 57,318 |
| Other items: | | | | | |
| Net investment income | \$ 20,076 | \$ 1,356 | \$ 539 | \$ 370 | \$ 22,341 |
| Depreciation and amortization | 1,207 | 1,925 | 126 | 452 | 3,710 |
| Interest expense (benefit) | 61 | 2,030 | 189 | (472) | 1,808 |
| Capital expenditures | 598 | 590 | | 402 | 1,590 |
| Income tax expense | 21,161 | 6,010 | 224 | 477 | 27,872 |
| Inter-segment eliminations | | | | | 1,311 |
| Consolidated income tax expense | | | | | \$ 29,183 |

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited, tables in thousands, except per share data)

The following tables present selected revenue items by line of business.

| | Three months ended March 31, | |
|----------------------------------|---------------------------------|-------------------|
| | 2006 | 2005 |
| Diversified financial products | \$ 169,112 | \$ 106,851 |
| Group life, accident and health | 127,761 | 128,945 |
| Aviation | 33,197 | 33,817 |
| London market account | 21,928 | 26,711 |
| Other specialty lines | 28,640 | 21,225 |
| Discontinued lines | (67) | 2,568 |
| Net earned premium | \$ 380,571 | \$ 320,117 |
| Property and casualty | \$ 25,206 | \$ 27,519 |
| Accident and health | 6,262 | 5,557 |
| Fee and commission income | \$ 31,468 | \$ 33,076 |

(6) SUPPLEMENTAL INFORMATION

Supplemental cash flow information was as follows.

| | Three months ended March 31, | |
|---------------------------------|------------------------------|----------|
| | 2006 | 2005 |
| Cash received from commutations | \$ | \$32,635 |
| Income taxes paid | 16,038 | 13,886 |
| Interest paid | 2,935 | 2,106 |
| Comprehensive income | 62,293 | 39,705 |

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited, tables in thousands, except per share data)

(7) COMMITMENTS AND CONTINGENCIES

Litigation

We are party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which, we believe, have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits, arbitrations and other proceedings that relate to disputes over contractual relationships with third parties, or that involve alleged errors and omissions on the part of our subsidiaries. We have provided accruals for these items to the extent we deem the losses probable and reasonably estimable.

We are presently engaged in litigation initiated by the appointed liquidator of a former reinsurer concerning payments made to us prior to the date of appointment of the liquidator. The disputed payments, totaling \$10.3 million, were made by the now insolvent reinsurer in connection with a commutation agreement. Our understanding is that such litigation is similar to other actions brought by the liquidator. We continue to vigorously contest the action.

In April 2006, we were named as a defendant in a complaint related to insurance marketing and producer compensation practices. The lawsuit was filed in Federal District Court in Georgia by a number of corporate plaintiffs against approximately 100 insurance entity defendants. The complaint alleges violations of Federal antitrust law, the Racketeer Influenced and Corrupt Organizations Act and various state anti-fraud laws. The lawsuit seeks unspecified damages. We intend to vigorously contest the action.

Although the ultimate outcome of the matters mentioned above cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from our outside legal counsel, we believe the resolution of these matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Indemnifications

In conjunction with the sales of business assets and subsidiaries, we have provided indemnifications to the buyers. Certain indemnifications cover typical representations and warranties related to our responsibilities to perform under the sales contracts. We cannot quantify the maximum potential exposure covered by all of our indemnifications because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. For those with a time limit, the longest such indemnification expires on December 31, 2009.

We accrue a loss related to our indemnifications when a valid claim is made by a buyer and we believe we have potential exposure. We currently have several claims under indemnifications that cover certain net losses incurred in periods prior to our sale of certain subsidiaries. As of March 31, 2006, we have recorded a liability of \$19.9 million and have provided \$8.1 million of letters of credit to cover our obligations or anticipated payments under these indemnifications.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Overview**

We are a specialty insurance group with offices in the United States, the United Kingdom, Spain, Bermuda and Ireland transacting business in more than 50 countries. Our group consists of insurance companies, underwriting agencies and reinsurance brokers. Our shares are traded on the New York Stock Exchange and had a market capitalization of \$3.9 billion at March 31, 2006. We earned \$78.6 million or \$0.67 per diluted share in the first quarter of 2006 compared to \$57.3 million or \$0.54 in 2005, despite the dilution from a \$150.0 million common stock offering in November 2005. Shareholders' equity increased by 25% from a year ago to \$1.8 billion at March 31, 2006, principally from a combination of net earnings and the 2005 equity offering.

We underwrite a variety of specialty lines of business identified as diversified financial products; group life, accident and health; aviation; London market account; and other specialty lines of business. Products in each line are marketed by our insurance companies and agencies, either through a network of independent agents and brokers, or directly to customers. With the exception of our public company directors' and officers' liability business, certain international aviation risks and our London market business, the majority of our business is generally lower limit, smaller premium business that is less susceptible to price competition, severity of loss or catastrophe risk. Our major insurance companies are rated AA (Very Strong) by Standard & Poor's Corporation and A+ (Superior) by A.M. Best Company, Inc.

We generate our revenue from four primary sources: 1) risk-bearing earned premium produced by our insurance company operations, 2) non-risk-bearing fee and commission income received by our underwriting agency and intermediary operations, 3) ceding commissions in excess of policy acquisition costs earned by our insurance company operations and 4) investment income earned by all of our operations. We produced \$466.1 million of revenue in the first quarter of 2006, an increase of 23% over the first quarter of 2005. The increase was due to higher net earned premium from increased retentions in our diversified financial products line of business, organic growth in certain lines of business and from acquisitions, increased investment income from a 32% growth in total investments and an increase in interest rates, and an increase in other operating income.

During the past several years, we substantially increased our shareholders' equity by retaining most of our earnings and issuing additional shares of common stock. With this additional equity, we increased the underwriting capacity of our insurance companies and made strategic acquisitions, adding new lines of business or expanding those with favorable underwriting characteristics.

Our 2005 acquisitions are listed below. Net earnings and cash flows from each acquired entity are included in our operations beginning on the effective date of each transaction.

| Company | Segment | Effective date acquired |
|-------------------------------------|-------------------|-------------------------|
| United States Surety Company | Insurance company | March 1, 2005 |
| HCC International Insurance Company | Insurance company | July 1, 2005 |
| Perico Life Insurance Company | Insurance company | November 30, 2005 |
| Perico Ltd. | Agency | December 1, 2005 |
| Illium Insurance Group | Agency | December 31, 2005 |

The following section discusses our key operating results. Amounts in the following tables are in thousands, except for earnings per share, percentages, ratios and number of employees. Comparisons refer to first quarter 2006 compared to first quarter 2005.

Table of Contents**Results of Operations**

Net earnings increased 37% to \$78.6 million (\$0.67 per diluted share) in 2006 from \$57.3 million (\$0.54 per diluted share) in 2005. Growth in underwriting profits, net investment income and other operating income contributed to the increase in 2006 earnings.

The following table sets forth the relationships of certain income statement items as a percent of total revenue.

| | Three months ended March 31, | |
|---------------------------------------|---------------------------------|--------------|
| | 2006 | 2005 |
| Net earned premium | 81.7% | 84.3% |
| Fee and commission income | 6.8 | 8.7 |
| Net investment income | 7.8 | 5.9 |
| Net realized investment loss | (0.3) | |
| Other operating income | 4.0 | 1.1 |
| Total revenue | 100.0 | 100.0 |
| Loss and loss adjustment expense, net | 47.3 | 49.0 |
| Policy acquisition costs, net | 16.8 | 15.6 |
| Other operating expense | 10.0 | 12.1 |
| Interest expense | 0.5 | 0.5 |
| Earnings before income tax expense | 25.4 | 22.8 |
| Income tax expense | 8.5 | 7.7 |
| Net earnings | 16.9% | 15.1% |

Total revenue increased 23% to \$466.1 million in 2006, driven by significant growth in net earned premium, investment income and other operating income, which more than offset the expected decrease in fee and commission income. We expect total revenue to continue to grow throughout 2006.

Gross written premium, net written premium and net earned premium are detailed below. Premium increased from organic growth in certain lines of business and from acquisitions. Increased retentions, particularly in our diversified financial products line of business, contributed to the growth in net written and earned premiums. See the Insurance Company Segment section below for further discussion of the relationship and changes in premium revenue.

| | Three months ended March 31, | |
|------------------------------|------------------------------|-----------|
| | 2006 | 2005 |
| Gross written premium | \$506,058 | \$475,119 |
| Net written premium | 393,051 | 357,352 |
| Net earned premium | 380,571 | 320,117 |

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Fee and commission income are shown in the table below. Fee and commission income decreased slightly due to our insurance company subsidiaries ceding less insurance, thereby reducing ceding commissions earned by them and reinsurance commissions earned by our reinsurance intermediaries.

| | Three months ended March 31, | |
|----------------------------------|---------------------------------|------------------|
| | 2006 | 2005 |
| Agency | \$ 23,061 | \$ 22,469 |
| Insurance companies | 8,407 | 10,607 |
| Fee and commission income | \$ 31,468 | \$ 33,076 |

The sources of net investment income are detailed below.

| | Three months ended March 31, | |
|------------------------------|---------------------------------|------------------|
| | 2006 | 2005 |
| Fixed income securities | \$ 24,305 | \$ 17,506 |
| Short-term investments | 7,540 | 4,193 |
| Other investments | 6,412 | 1,767 |
| Total investment income | 38,257 | 23,466 |
| Investment expense | (1,676) | (1,125) |
| Net investment income | \$ 36,581 | \$ 22,341 |

Net investment income increased 64% in 2006. This increase was primarily due to higher investment assets, which increased to \$3.4 billion at March 31, 2006 compared to \$2.6 billion at March 31, 2005, increasing interest rates and a better than expected yield on alternative investments. The growth in investment assets resulted from: 1) higher net earnings, 2) higher retentions, 3) commutations of reinsurance recoverables in late 2005, 4) our public offering of common stock in 2005 and 5) the increase in net loss reserves particularly from our diversified financial products line of business, which generally has a longer time period between occurrence and payment of claims. We continue to invest our funds primarily in fixed income securities, slightly extending their duration to 5.0 years at March 31, 2006 from 4.8 years at March 31, 2005 and increasing the percentage of tax-exempt municipal bonds in our investment portfolio. We expect investment assets and investment income to continue to increase in 2006.

At March 31, 2006, our unrealized loss on fixed income securities was \$32.4 million, compared to an unrealized loss of \$8.5 million at December 31, 2005, due to increases in market interest rates. The change in the unrealized gain or loss, net of the related income tax effect, is recorded in other comprehensive income. This loss is unlikely to affect future net earnings as we often hold our fixed income securities to maturity when we receive the full principal amount. Information about our portfolio of fixed income securities is as follows:

| | Three months ended March 31, | |
|------------------------------|---------------------------------|-------|
| | 2006 | 2005 |
| Average yield | 4.12% | 3.92% |
| Average tax equivalent yield | 5.04% | 4.82% |

| | | |
|---------------------------|-----------|-----------|
| Weighted-average maturity | 7.8 years | 7.4 years |
| Weighted-average duration | 5.0 years | 4.8 years |

The average yield on our short-term investments increased from 2.5% in 2005 to 4.2% in 2006.

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Other operating income increased \$14.6 million in 2006. The increase related primarily to a gain from the partial sale of a strategic investment and net gains from trading securities. Period to period comparisons of other operating income may vary substantially depending on market values of trading securities and other financial instruments and on income from strategic investments or dispositions of such investments. The following table details the source of our other operating income.

| | Three months ended March 31, | |
|-------------------------------|---------------------------------|-----------------|
| | 2006 | 2005 |
| Strategic investments | \$ 12,205 | \$ 1,073 |
| Trading securities | 4,686 | (269) |
| Financial instruments | 823 | 2,289 |
| Other | 1,036 | 1,054 |
| Other operating income | \$ 18,750 | \$ 4,147 |

Loss and loss adjustment expense increased 19% and policy acquisition costs increased 32% in 2006 primarily due to the growth in net earned premium. See the Insurance Company Segment section below for further discussion of the changes in loss and loss adjustment expense and policy acquisition costs.

Other operating expense, which includes compensation expense, increased 2% in 2006. The increase primarily related to stock option expense under Statement of Financial Accounting Standards (SFAS) No. 123(R) and operating expenses of subsidiaries acquired in the second half of 2005, partially offset by lower legal and accounting expenses.

We had 1,458 employees at March 31, 2006 compared to 1,262 a year earlier, with the increase due to acquisitions.

See the Recent Accounting Changes section below for further discussion of our adoption of SFAS 123(R) in 2006.

Our effective income tax rate was 33.6% for 2006, compared to 33.7% for 2005.

At March 31, 2006, book value per share was \$15.82, up from \$15.29 at December 31, 2005. Total assets were \$7.1 billion and shareholders' equity was \$1.8 billion, up from \$7.0 billion and \$1.7 billion, respectively, at December 31, 2005.

Segments***Insurance Company Segment***

Net earnings of our insurance company segment increased 21% to \$58.8 million in the first quarter of 2006 compared to \$48.5 million in the first quarter of 2005. The growth in segment net earnings was driven by an increase in underwriting income, increased investment income and the operations of acquired subsidiaries. Even though there is some pricing competition in certain of our markets, our margins remain at an acceptable level of profitability due to our underwriting expertise and discipline. We expect net earnings from our insurance companies to continue to grow during 2006.

Premium

Gross written premium increased 7% to \$506.1 million in 2006. Net written premium increased 10% to \$393.1 million and net earned premium increased 19% to \$380.6 million in 2006. These increases were primarily due to higher retention levels on non-catastrophe business, acquisitions and the mix of business due to increased premium in lines where we had greater retentions. The overall percentage of retained premium increased to 78% in 2006 from 75% in 2005. Net written and net earned premium are expected to continue to grow in 2006.

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The following tables provide premium information by line of business.

| | Gross written premium | Net written premium | NWP as % of GWP | Net earned premium |
|-----------------------------------|-----------------------------|---------------------------|-----------------------|--------------------------|
| Three months ended March 31, 2006 | | | | |
| Diversified financial products | \$ 197,246 | \$ 161,645 | 82% | \$ 169,112 |
| Group life, accident and health | 134,154 | 129,443 | 96 | 127,761 |
| Aviation | 56,234 | 35,425 | 63 | 33,197 |
| London market account | 74,507 | 38,723 | 52 | 21,928 |
| Other specialty lines | 43,889 | 27,900 | 64 | 28,640 |
| Discontinued lines | 28 | (85) | nm | (67) |
| Totals | \$ 506,058 | \$ 393,051 | 78% | \$ 380,571 |

Three months ended March 31, 2005

| | | | | |
|---------------------------------|-------------------|-------------------|------------|-------------------|
| Diversified financial products | \$ 199,072 | \$ 145,997 | 73% | \$ 106,851 |
| Group life, accident and health | 150,082 | 129,449 | 86 | 128,945 |
| Aviation | 49,102 | 32,126 | 65 | 33,817 |
| London market account | 43,196 | 28,912 | 67 | 26,711 |
| Other specialty lines | 35,519 | 21,074 | 59 | 21,225 |
| Discontinued lines | (1,852) | (206) | nm | 2,568 |
| Totals | \$ 475,119 | \$ 357,352 | 75% | \$ 320,117 |

nm Not meaningful comparison

The changes in premium volume and retention levels between years resulted principally from the following factors:

Diversified financial products Gross written premium was flat. Growth in our surety line of business from both organic growth and our 2005 acquisitions was offset by lower premium volume in our international directors and officers liability and professional indemnity books of business due to competitive pricing pressure, although profit margins on these lines remain at acceptable levels. The growth in net written and net earned premium was due to increased retentions resulting from a reduction in proportional reinsurance.

Group life, accident and health Gross written premium declined primarily because we non-renewed a book of business which was 100% reinsured. Profit margins remain at acceptable levels despite competition from the fully insured market.

London market account Gross written premium increased due to the substantial increase in rates in the energy sector as a result of the 2005 hurricane losses, more than offsetting a reduction in our property premium. Net written premium increased for the same reason and will be reflected in increases in our net earned premium later in 2006 and into 2007. In 2006, to increase our capacity and spread our risk in the energy sector, we entered into a new quota share reinsurance agreement, which resulted in a decrease in our retention although net written premium has still increased. Although the cost of our 2006 excess of loss reinsurance increased, our potential profitability is greater on the increased gross written premium. The reduction in property premium has reduced our aggregate exposure in Florida and the Gulf of Mexico.

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Other specialty lines We experienced organic growth in our other specialty lines of business from increased writings in several products. The mix of products affected the retention percentages. Rates in this line have been relatively stable.

Losses and Loss Adjustment Expenses

Our net adverse development relating to prior year losses included in net incurred loss and loss adjustment expense was \$2.6 million in 2006 and \$1.6 million in 2005. Deficiencies and redundancies in reserves occur as a result of our continuing review and as losses are finally settled or claims exposures change. We have no material exposure to environmental or asbestos losses and believe we have provided for all material net incurred losses.

Our gross loss ratio was 55.3% in 2006 and 55.7% in 2005. The following table provides comparative net loss ratios by line of business, which were relatively consistent with the prior year ratios.

| | Three months ended March 31, | | | |
|---------------------------------|------------------------------|----------------------|--------------------------|----------------------|
| | 2006 | | 2005 | |
| | Net earned premium | Net loss ratio | Net earned premium | Net loss ratio |
| Diversified financial products | \$ 169,112 | 50.8% | \$ 106,851 | 49.1% |
| Group life, accident and health | 127,761 | 69.7 | 128,945 | 69.0 |
| Aviation | 33,197 | 54.3 | 33,817 | 51.6 |
| London market account | 21,928 | 48.1 | 26,711 | 44.6 |
| Other specialty lines | 28,640 | 58.7 | 21,225 | 59.7 |
| Discontinued lines | (67) | nm | 2,568 | 102.1 |
| Totals | \$ 380,571 | 58.0% | \$ 320,117 | 58.1% |
| Expense ratio | | 27.2 | | 26.4 |
| Combined ratio | | 85.2% | | 84.5% |

nm Not meaningful comparison

Policy Acquisition Costs

Policy acquisition costs, which are net of the related portion of commissions on reinsurance ceded, increased to \$78.2 million in the first quarter of 2006 from \$59.4 million in the first quarter of 2005. Policy acquisition costs as a percentage of net earned premium increased to 20.6% in 2006 from 18.5% in 2005 due to a change in the mix of business and higher retention rates. The expense ratio increased in 2006 compared to 2005 for the same reasons.

Agency Segment

Revenue from our agency segment decreased to \$42.7 million in the first quarter of 2006 from \$45.2 million in the first quarter of 2005, primarily due to less business produced in certain lines and the overall effect of ceding less reinsurance. In addition, we consolidated our largest underwriting agency into one of our life insurance companies effective January 1, 2005. As a result, segment net earnings also decreased in 2006 to \$8.4 million from \$9.0 million in 2005. While increased retentions result in less fee and commission income to our agency segment, they generate increased insurance company revenue and net earnings. We expect the revenue and net earnings of this segment will stabilize in 2006 and only decline slightly due to continuing changes in the mix of business, but should begin to increase again in 2007.

Table of Contents**Other Operations Segment**

Revenue and net earnings from our other operations segment increased to \$19.8 million and \$13.0 million, respectively, in 2006 compared to 2005 primarily due to the partial sale of a strategic investment and net gains from trading securities. Results of this segment may vary substantially period to period depending on our investment in or disposition of strategic investments and activity in our trading portfolio. The trading portfolio represents less than 3% of our total investments.

Liquidity and Capital Resources

We receive substantial cash from premiums, reinsurance recoverables, commutations, fee and commission income, proceeds from sales and redemptions of investments and investment income. Our principal cash outflows are for the payment of claims and loss adjustment expenses, premium payments to reinsurers, purchases of investments, debt service, policy acquisition costs, operating expenses, taxes and dividends.

Cash provided by operating activities can fluctuate due to timing differences in the collection of premiums and reinsurance recoverables and the payment of losses and premium and reinsurance balances payable, the completion of commutations and activity in our trading portfolio. Our cash provided by operating activities has been strong in recent years due to: 1) our increasing net earnings, 2) growth in net written premium and net loss reserves due to organic growth, acquisitions and increased retentions, 3) commutations of selected reinsurance agreements and 4) expansion of our diversified financial products line of business as a result of which we retain premium longer due to the longer duration of claims liabilities.

The components of our net operating cash flows are detailed in the following table.

| | Three months ended March 31, | |
|---|---------------------------------|------------------|
| | 2006 | 2005 |
| Net earnings | \$ 78,551 | \$ 57,318 |
| Change in premium, claims and other receivables, net of reinsurance, other payables and restricted cash | (13,013) | (63,735) |
| Change in unearned premium, net | 18,152 | 35,458 |
| Change in loss and loss adjustment expense payable, net of reinsurance recoverables | 34,907 | 49,115 |
| Change in trading portfolio | (47,994) | (41,328) |
| Other, net | 7,334 | (2,919) |
| Cash provided by operating activities | \$ 77,937 | \$ 33,909 |

Cash provided by operating activities increased \$44.0 million in 2006. Cash received from commutations, included in cash provided by operating activities, totaled \$32.6 million in 2005. Cash flow from operations was unusually low in 2005 due to the timing of receipt of premiums and payment of payables.

Our combined cash and investment portfolio increased by \$84.1 million during 2006 to a total of \$3.4 billion at March 31, 2006. We maintain a substantial level of cash and liquid short-term investments to meet anticipated payment obligations.

In 2006, we paid \$24.0 million, which had been accrued at December 31, 2005, related to an earnout consideration based on the terms of a prior acquisition agreement.

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Our \$200.0 million Revolving Loan Facility allows us to borrow up to the maximum allowed by the facility on a revolving basis until the facility expires on November 30, 2009. We had no borrowings at March 31, 2006. We have filed registration statements with the United States Securities and Exchange Commission that provide for the issuance of an aggregate of \$750.0 million of our securities, of which \$375.0 million remains available to be issued. These securities may be debt securities, equity securities or a combination thereof.

As a result of our common stock trading at specified price levels in the first quarter, holders may elect to surrender our 1.30% Convertible Notes and 2.00% Convertible Exchange Notes (Notes) in the second quarter for cash equal to the principal amount of the Notes (\$297.4 million at March 31, 2006) and common stock for the value of the conversion premium. We expect to use the Revolving Loan Facility to fund any Notes surrendered in the second quarter, which have been minimal to date. Assuming an average price of \$34.00 for our stock, we would issue approximately 4.9 million shares of common stock should all Note holders elect conversion. The dilutive effect of these shares is included in the calculation of our diluted earnings per share in all periods despite the fact that no material conversions have been made and none are expected at this time. Our common stock must meet the specified price levels in each subsequent quarter in order for the Notes to be eligible for conversion in the following quarter.

Our debt to total capital ratio was 15.0% at March 31, 2006 and 15.5% at December 31, 2005.

We believe that our operating cash flows, investments, Revolving Loan Facility and shelf registration will provide sufficient sources of liquidity to meet our current operating needs for the foreseeable future.

Recent Accounting Changes

Effective January 1, 2006, we adopted SFAS No. 123(R), *Share-Based Payment*, using the modified prospective method. In 2006 and thereafter, we will expense the fair value of our unvested stock options granted before January 1, 2006 and all options granted after that date. Prior to adoption, we accounted for our stock options in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Under APB 25, we did not record compensation expense because the exercise price of our options granted equaled the market price of our stock on the grant date. Under the modified prospective method of SFAS 123(R), the 2005 and prior period financial statements were not restated. We made no modifications to our stock option plans in conjunction with the adoption of SFAS 123(R).

In the first quarter of 2006, we expensed \$2.3 million (\$1.7 million after tax or \$0.01 per diluted share) of stock-based compensation, after the effect of the deferral and amortization of related policy acquisition costs. At March 31, 2006, there was approximately \$33.6 million of total unrecognized compensation expense related to unvested options that is expected to be recognized over a weighted-average period of three years. In 2006, we expect to recognize \$10.4 million of expense, including the amortization of deferred policy acquisition costs, related to stock-based compensation for options currently outstanding.

Critical Accounting Policies

We have made no changes in our methods of application of our critical accounting policies from the information provided in our Annual Report on Form 10-K for the year ended December 31, 2005.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in market risk from the information provided in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in our Annual Report on Form 10-K for the year ended December 31, 2005.

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Item 4. Controls and Procedures

(a) Disclosure Controls and Procedures

As of March 31, 2006, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the Act). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us to comply with our disclosure obligations under the Act is recorded, processed, summarized and reported by us within the timeframes specified by the Securities and Exchange Commission in order to comply with our disclosure obligations under the Act.

(b) Changes in Internal Control over Financial Reporting

During the first quarter of 2006, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II Other Information

Item 1. Legal Proceedings

We are party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which, we believe, have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits, arbitrations and other proceedings that relate to disputes over contractual relationships with third parties, or that involve alleged errors and omissions on the part of our subsidiaries. We have provided accruals for these items to the extent we deem the losses probable and reasonably estimable.

In April 2006, we were named as a defendant in a complaint related to insurance marketing and producer compensation practices. The lawsuit was filed in Federal District Court in Georgia by a number of corporate plaintiffs against approximately 100 insurance entity defendants. The complaint alleges violations of Federal antitrust law, the Racketeer Influenced and Corrupt Organizations Act and various state anti-fraud laws. The lawsuit seeks unspecified damages. We intend to vigorously contest the action.

Although the ultimate outcome of the matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from our outside legal counsel, we believe the resolution of these matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Item 1A. Risk Factors

There have been no material changes in our risk factors described in our Annual Report on Form 10-K for the year ended December 31, 2005.

Item 6. Exhibits

a. Exhibits

31.1 Certification by Chief Executive Officer

31.2 Certification by Chief Financial Officer

32.1 Certification with Respect to Quarterly Report

SIGNATURES

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

HCC Insurance Holdings, Inc.

(Registrant)

May 9, 2006

/s/ Stephen L. Way

(Date)

Stephen L. Way, Chairman of the Board
and Chief Executive Officer

May 9, 2006

/s/ Edward H. Ellis, Jr.

(Date)

Edward H. Ellis, Jr., Executive Vice President
and Chief Financial Officer

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Exhibit Index

- 31.1 Certification by Chief Executive Officer
- 31.2 Certification by Chief Financial Officer
- 32.1 Certification with respect to quarterly report