

HealthMarkets, Inc.  
Form 10-Q  
May 14, 2007

**Table of Contents**

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

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007.  
OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_  
COMMISSION FILE NO. 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 No.)

9151 Boulevard 26, North Richland Hills, Texas

76180

(Address of principal executive office)

(Zip Code)

Registrant's telephone number, including area code: (817) 255-5200

Not Applicable

Former name, former address and former fiscal year, if changed since last report.

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.

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 issuer's classes of common stock, as of the latest practicable date. On April 30, 2007 the registrant had 26,900,160 outstanding shares of Class A-1 Common Stock, \$.01 Par Value, and 3,299,773 outstanding shares of Class A-2 Common Stock, \$.01 Par Value.

INDEX  
HEALTHMARKETS, INC. AND SUBSIDIARIES

	PAGE
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	
<u>Consolidated condensed balance sheets March 31, 2007 (unaudited) and December 31, 2006</u>	3
<u>Consolidated condensed statements of income (unaudited) Three months ended March 31, 2007 and 2006</u>	4
<u>Consolidated condensed statements of comprehensive income (unaudited) Three months ended March 31, 2007 and 2006</u>	5
<u>Consolidated condensed statements of cash flows (unaudited) Three months ended March 31, 2007 and 2006</u>	6
<u>Notes to consolidated condensed financial statements (unaudited) March 31, 2007</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	26
<u>Item 4. Controls and Procedures</u>	26
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	27
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	27
<u>Item 6. Exhibits</u>	28
<u>SIGNATURES</u>	29
<u>Rule 13a-14(a)/15d-14(a) Certification</u>	
<u>Rule 13a-14(a)/15d-14(a) Certification</u>	
<u>Certifications Required by Rule 13a-14(b) or Rule 15d-14(b)</u>	

**Table of Contents**

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## HEALTHMARKETS, INC. AND SUBSIDIARIES

## CONSOLIDATED CONDENSED BALANCE SHEETS

(DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	<b>March 31, 2007 (Unaudited)</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
Investments		
Securities available for sale		
Fixed maturities, at fair value (cost: 2007 \$1,350,401; 2006 \$1,391,275)	\$ 1,335,589	\$ 1,374,403
Equity securities, at fair value (cost: 2007 \$283; 2006 \$283)	317	318
Policy loans	14,482	14,625
Short-term and other investments	500,566	412,498
Total Investments	1,850,954	1,801,844
Cash and cash equivalents	5,226	32,756
Student loans	103,307	105,846
Restricted cash	17,262	16,238
Investment income due and accrued	21,902	22,633
Due premiums	3,517	3,299
Reinsurance receivables	163,398	155,283
Agents and other receivables	38,463	39,232
Deferred acquisition costs	200,407	197,757
Property and equipment, net	63,838	64,436
Goodwill and other intangible assets	86,444	86,871
Recoverable federal income taxes	19,519	23,929
Other assets	47,693	38,205
	\$ 2,621,930	\$ 2,588,329

**LIABILITIES AND STOCKHOLDERS EQUITY**

Policy liabilities		
Future policy and contract benefits	\$ 456,865	\$ 453,715
Claims	532,227	517,132
Unearned premiums	146,783	151,758
Other policy liabilities	11,586	12,569
Accounts payable and accrued expenses	46,597	48,363
Other liabilities	100,544	128,018
Deferred federal income tax payable	81,029	73,575
Debt	556,070	556,070
Student loan credit facility	116,700	118,950

Edgar Filing: HealthMarkets, Inc. - Form 10-Q

Net liabilities of discontinued operations	3,539	3,794
	2,051,940	2,063,944
Commitments and Contingencies (Note E)		
Stockholders' Equity		
Preferred stock, par value \$0.01 per share		
Common stock, par value \$0.01 per share	304	300
Additional paid-in capital	30,899	12,529
Accumulated other comprehensive loss	(11,844)	(12,552)
Retained earnings	550,669	527,978
Treasury stock, at cost	(38)	(3,870)
	569,990	524,385
	\$ 2,621,930	\$ 2,588,329

NOTE: The balance sheet data as of December 31, 2006 has been derived from the audited financial statements at that date.

See Notes to Consolidated Condensed Financial Statements (Unaudited).

**Table of Contents**

HEALTHMARKETS, INC. AND SUBSIDIARIES  
 CONSOLIDATED CONDENSED STATEMENTS OF INCOME (UNAUDITED)  
 (DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	<b>Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
REVENUE		
Premiums:		
Health	\$ 333,762	\$ 442,550
Life premiums and other considerations	16,381	16,139
	350,143	458,689
Investment income	26,460	27,158
Other income	25,615	25,133
Gains on sales of investments	2,403	2,175
	404,621	513,155
BENEFITS AND EXPENSES		
Benefits, claims, and settlement expenses	215,331	272,725
Underwriting, acquisition, and insurance expenses	121,998	155,407
Variable non-cash stock-based compensation (benefit) expense	(1,551)	240
Other expenses	21,782	24,539
Interest expense	12,996	1,780
	370,556	454,691
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	34,065	58,464
Federal income taxes	11,441	19,618
INCOME FROM CONTINUING OPERATIONS	22,624	38,846
DISCONTINUED OPERATIONS		
Income from discontinued operations (net of income tax expense (benefit) of \$36 and \$(843) in the three months ended March 31, 2007 and 2006, respectively)	67	661
NET INCOME	\$ 22,691	\$ 39,507
Earnings per share:		
Basic		
Income from continuing operations	\$ 0.75	\$ 0.84
Income from discontinued operations		0.01
Net income	\$ 0.75	\$ 0.85
Diluted		
Income from continuing operations	\$ 0.73	\$ 0.83

Edgar Filing: HealthMarkets, Inc. - Form 10-Q

Income from discontinued operations			0.01
Net income	\$	0.73	\$ 0.84

See Notes to Consolidated Condensed Financial Statements (Unaudited).

4

---

**Table of Contents**

HEALTHMARKETS, INC. AND SUBSIDIARIES  
 CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)  
 (DOLLARS IN THOUSANDS)

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
Net income	\$ 22,691	\$ 39,507
Other comprehensive income (loss):		
Unrealized gains (losses) on securities and hedging activities:		
Unrealized holding gains (losses) arising during period	2,026	(22,079)
Reclassification adjustment for interest rate swaps included in net income	(60)	
Reclassification adjustment for investment gains (losses) included in net income	(877)	(12)
Other comprehensive income (loss) before tax	1,089	(22,091)
Income tax provision (benefit) related to items of other comprehensive income (loss)	381	(7,733)
Other comprehensive income (loss) net of tax provision (benefit)	708	(14,358)
Comprehensive income	\$ 23,399	\$ 25,149

See Notes to Consolidated Condensed Financial Statements (Unaudited).



**Table of Contents**

HEALTHMARKETS, INC. AND SUBSIDIARIES  
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS (UNAUDITED)  
(DOLLARS IN THOUSANDS)

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(In thousands)</b>	
<b>Operating Activities</b>		
Net income	\$ 22,691	\$ 39,507
Income from discontinued operations	(67)	(661)
Adjustments to reconcile net income to cash provided by operating activities:		
Gains on sales of investments	(2,403)	(2,175)
Change in accrued investment income	(69)	(1,113)
Change in due premiums	(218)	13,942
Change in reinsurance receivables	(8,115)	(1,260)
Change in other receivables	716	1,063
Change in federal income tax payable	11,483	18,513
Change in deferred acquisition costs	(2,650)	1,716
Depreciation and amortization	6,090	6,552
Change in policy liabilities	13,288	5,050
Change in other liabilities and accrued expenses	(7,889)	3,881
Variable non-cash stock-based compensation (benefit) expense	(1,551)	240
Change in prepaid monitoring fees	(9,375)	
Other items, net	1,432	819
Cash Provided by continuing operations	23,363	86,074
Cash (Used in) Provided by discontinued operations	(188)	268
Net cash Provided by operating activities	23,175	86,342
<b>Investing Activities</b>		
Increase in investment assets	(46,800)	(59,658)
Decrease in student loans	3,340	1,548
(Increase) decrease in restricted cash	(1,024)	407
Additions to property and equipment	(3,878)	(2,779)
Distribution from investment in Grapevine Finance LLC	468	
Decrease (increase) in agents' receivables	53	(5,593)
Net cash Used in investing activities	(47,841)	(66,075)
<b>Financing Activities</b>		
Increase in investment products	(1,001)	(3,682)
Repayment of student loan credit facility	(2,250)	(1,750)
Exercise of stock options	25	114
Purchase of treasury stock	(38)	
Change in cash overdraft		(3,736)

Edgar Filing: HealthMarkets, Inc. - Form 10-Q

Other	400	39
Net Cash Used in financing activities	(2,864)	(9,015)
Net change in Cash and cash equivalents	(27,530)	11,252
Cash and cash equivalents at beginning of period	32,756	
Cash and cash equivalents at end of period in continuing operations	\$ 5,226	\$ 11,252

See Notes to Consolidated Condensed Financial Statements (Unaudited).

6

---

**Table of Contents**

## HEALTHMARKETS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

March 31, 2007

## NOTE A BASIS OF PRESENTATION

The accompanying unaudited consolidated condensed financial statements for HealthMarkets, Inc. (the Company or HealthMarkets) and its subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States of America (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, all adjustments considered necessary for a fair presentation have been included. All such adjustments, except as otherwise described herein, consist of normal recurring accruals. Operating results for the three month period ended March 31, 2007 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2007. 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, 2006.

Certain amounts in the 2006 consolidated condensed financial statements have been reclassified to conform to the 2007 consolidated condensed financial statement presentation.

**Recently Issued Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement 157, *Fair Value Measurement* (SFAS 157), which defines fair value as the price that would be received to sell an asset or that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. Statement 157 will be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company believes this statement will not have a material effect upon the financial condition or results of operations of the Company.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109 *Accounting for Income Taxes*. The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of the tax benefits from the tax position taken or expected to be taken in a tax return. Guidance is also provided on derecognition, classification, interest and penalties, interim accounting, and disclosure. The cumulative effect of applying the provisions of this Interpretation, if any, is to be reported as an adjustment to the opening balance of retained earnings. Interest plus applicable penalties, if any, on the difference between the tax benefit recognized on a tax return and the tax benefit recognized in the financial statements are accrued at the applicable statutory interest and penalty rates. The Interpretation applies to all tax positions and became effective for the Company on January 1, 2007. Adoption of this pronouncement did not affect the Company's financial position and no cumulative effect adjustment was required to the January 1, 2007 balance of retained earnings. In addition, the Company elected to report as income taxes the accrued interest and applicable penalties, if any, on uncertain tax positions.

In 2005, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*, for implementation in the first quarter of 2007. The SOP requires that deferred acquisition costs be expensed in full when the original contract is substantially changed by election or amendment of an existing contract feature or by replacement with a new contract. The Company implemented the SOP for contract changes beginning in the first quarter of 2007 with no material effects to the financial statements at implementation.

## NOTE B DEBT

In connection with the Merger completed on April 5, 2006, HealthMarkets, LLC entered into a credit agreement, providing for a \$500.0 million term loan facility and a \$75.0 million revolving credit facility (which includes a \$35.0 million letter of credit sub-facility). The full amount of the term loan was drawn at closing, and the proceeds thereof were used to fund a portion of the consideration paid in the Merger. At March 31, 2007, the Company had an

**Table of Contents**

aggregate of \$437.5 million of indebtedness outstanding under the term loan facility, which indebtedness bore interest at the London inter-bank offered rate ( LIBOR ) plus a borrowing margin (1.00%). The Company has not drawn on the \$75.0 million revolving credit facility.

The revolving credit facility will mature on April 5, 2011, and the term loan facility will mature on April 5, 2012. The term loan required nominal quarterly installments (not exceeding 0.25% of the aggregate principal amount at the date of issuance) until the maturity date at which time the remaining principal amount is due. As a result of a \$60.0 million prepayment in 2006, the Company is not obligated to make future nominal quarterly installments as previously required by the credit agreement. Borrowings under the credit agreement may be subject to certain mandatory prepayments. At HealthMarkets, LLC's election, the interest rates per annum applicable to borrowings under the credit agreement will be based on a fluctuating rate of interest measured by reference to either (a) LIBOR plus a borrowing margin, or (b) a base rate plus a borrowing margin. HealthMarkets, LLC will pay (a) fees on the unused loan commitments of the lenders, (b) letter of credit participation fees for all letters of credit issued, plus fronting fees for the letter of credit issuing bank, and (c) other customary fees in respect of the credit facility. Borrowings and other obligations under the credit agreement are secured by a pledge of HealthMarkets, LLC's interest in substantially all of its subsidiaries, including the capital stock of 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 ).

On April 5, 2006, HealthMarkets Capital Trust I and HealthMarkets Capital Trust II (two newly formed Delaware statutory business trusts) (collectively the Trusts ) issued \$100.0 million of floating rate trust preferred securities (the Trust Securities ) and \$3.1 million of floating rate common securities. The Trusts invested the proceeds from the sale of the Trust Securities, together with the proceeds from the issuance to HealthMarkets, LLC by the Trusts of the common securities, in \$100.0 million principal amount of HealthMarkets, LLC's Floating Rate Junior Subordinated Notes due June 15, 2036 (the Notes ), of which \$50.0 million principal amount accrue interest at a floating rate equal to three-month LIBOR plus 3.05% and \$50.0 million principal amount accrue interest at a fixed rate of 8.367% through but excluding June 15, 2011 and thereafter at a floating rate equal to three-month LIBOR plus 3.05%. Distributions on the Trust Securities will be paid at the same interest rates paid on the Notes.

The Notes, which constitute the sole assets of the Trusts, are subordinate and junior in right of payment to all senior indebtedness (as defined in the Indentures) of HealthMarkets, LLC. The Company has fully and unconditionally guaranteed the payment by the Trusts of distributions and other amounts payable under the Trust Securities. The guarantee is subordinated to the same extent as the Notes.

The Trusts are obligated to redeem the Trust Securities when the Notes are paid at maturity or upon any earlier prepayment of the Notes. Prior to June 15, 2011, the Notes may be redeemed only upon the occurrence of certain tax or investment company events at 105.0% of the principal amount thereof in the first year reducing by 1.25% per year until it reaches 100.0%. On and after June 15, 2011 the Notes are redeemable, in whole or in part, at the option of the Company at 100.0% of the principal amount thereof.

On April 29, 2004, UICI Capital Trust I (a newly formed Delaware statutory business trust) (the 2004 Trust ) completed the private placement of \$15.0 million aggregate issuance amount of floating rate trust preferred securities with an aggregate liquidation value of \$15.0 million (the 2004 Trust Preferred Securities ). The 2004 Trust invested the \$15.0 million proceeds from the sale of the 2004 Trust Preferred Securities, together with the proceeds from the issuance to the Company by the 2004 Trust of its floating rate common securities in the amount of \$470,000 (the Common Securities ) and, collectively with the 2004 Trust Preferred Securities, the 2004 Trust Securities ), in an equivalent face amount of the Company's Floating Rate Junior Subordinated Notes due 2034 (the 2004 Notes ). The 2004 Notes will mature on April 29, 2034, which date may be accelerated to a date not earlier than April 29, 2009. The 2004 Notes may be prepaid prior to April 29, 2009, at 107.5% of the principal amount thereof, upon the occurrence of certain events, and thereafter at 100.0% of the principal amount thereof. The 2004 Notes, which constitute the sole assets of the 2004 Trust, are subordinate and junior in right of payment to all senior indebtedness (as defined in the Indenture, dated April 29, 2004, governing the terms of the 2004 Notes) of the Company. The 2004 Notes accrue interest at a floating rate equal to three-month LIBOR plus 3.50%, payable quarterly on February 15, May 15, August 15, and November 15 of each year. At March 31, 2007, the 2004 Notes bore interest at an annual rate

of 8.86%. The quarterly distributions on the 2004 Trust Securities are paid at the same interest rate paid on the 2004 Notes.

The following table sets forth detail of the Company's debt and interest expense (dollars in thousands):

8

---

**Table of Contents**

	<b>Principal Amount</b>	<b>Interest rate</b>	<b>Interest Expense</b>
	<b>at March 31, 2007</b>	<b>at March 31, 2007</b>	<b>Three Months Ended 2007</b>
<i>2006 credit agreement:</i>			
Term loan	\$ 437,500	6.36%	\$ 6,680
\$75 Million revolver (non-use fee)			41
<i>Trust preferred securities:</i>			
UICI Capital Trust I	15,470	8.86%	343
HealthMarkets Capital Trust I	51,550	8.40%	1,084
HealthMarkets Capital Trust II	51,550	8.37%	1,078
<i>Other:</i>			
Interest on Deferred Tax			1,042
Student loan credit facility	116,700	5.30%	1,541
Amortization of financing fees			1,187
<b>Total</b>	<b>\$ 672,770</b>		<b>\$ 12,996</b>

Set forth below is the supplemental calculation of the amortization of financing fees included in interest expense associated with the Company's non-student loan debt (dollars in thousands):

	<b>Remaining capitalized</b>	<b>Life (years)</b>	<b>Amortization Expense Three months ended March 31, 2007</b>
	<b>amount</b>		
UICI Capital Trust I	\$ 176	5	\$ 21
Term loan credit facility	17,563	6	753
HealthMarkets Capital Trust I	2,496	5	128
HealthMarkets Capital Trust II	2,499	5	127
\$75 Million Revolver (Non-Use Fee)	2,529	5	158
<b>Total</b>	<b>\$ 25,263</b>		<b>\$ 1,187</b>

Principal payments required for the Company's non-student loan debt for the remainder of 2007 and each of the next five years and thereafter are as follows (in thousands):

Remainder of 2007	\$ 0
2008	0
2009	0
2010	0
2011	0
2012	437,500
2013 and thereafter	118,570

Management uses derivative instruments to protect against the risk of changes in prevailing interest rates adversely affecting future cash flows associated with the term loan credit facility discussed above. The derivative instrument used by the Company to protect against such risk is the interest rate swap. The Company accounts for its interest rate swaps in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*.

As with any financial instrument, derivative instruments have inherent risks, primarily market and credit risk. Market risk associated with changes in interest rates is managed as part of the Company's overall market risk monitoring process by establishing and monitoring limits as to the degree of risk that may be undertaken. Credit risk occurs when a counterparty to a derivative contract in which the Company has an unrealized gain fails to perform according to the terms of the agreement. The Company minimizes its credit risk by entering into transactions with counterparties that maintain high credit ratings.

For a derivative instrument designated as a cash flow hedge, the effective portion of changes in the fair value of the derivative instrument is recorded under the caption "Unrealized gains (losses) on securities and hedging activities" in the Company's Consolidated Condensed Statement of Comprehensive Income and is recognized in the

**Table of Contents**

income statement when the hedged item affects results of operations. If it is determined that (i) an interest rate swap is not highly effective in offsetting changes in the cash flows of a hedged item, (ii) the derivative expires or is sold, terminated or exercised, or (iii) the derivative is undesignated as a hedge instrument because it is unlikely that a forecasted transaction will occur, the Company discontinues hedge accounting prospectively.

If hedge accounting is discontinued, the derivative instrument will continue to be carried at fair value, with changes in the fair value of the derivative instrument recognized in the current period's results of operations. When hedge accounting is discontinued because it is probable that a forecasted transaction will not occur, the accumulated gains and losses included in accumulated other comprehensive income will be recognized immediately in results of operations. When hedge accounting is discontinued because the derivative instrument has not been or will not continue to be highly effective as a hedge, hedge accounting is discontinued and the remaining amount in accumulated other comprehensive income is amortized into earnings over the remaining life of the derivative.

At the effective date of the Merger, an affiliate of The Blackstone Group assigned to the Company three interest rate swap agreements with an aggregate notional amount of \$300.0 million. The terms of the swaps are 3, 4 and 5 years beginning on April 11, 2006. The Company presents the fair value of the interest rate swap agreements at the end of the period in either Other assets or Other liabilities, as applicable, on its consolidated condensed balance sheet. At March 31, 2007, the interest rate swaps had an aggregate fair value of approximately \$912,000, which is reflected under the caption Other liabilities. The Company redesignated the hedging relationship in February 2007 to hedge the risk of changes in the Company's cash flow attributable to changes in the LIBOR rate applicable to its variable-rate term loan. The Company assesses, on a quarterly basis, the ineffectiveness of the hedging relationship and any gains or losses related to the ineffectiveness are recorded in Other investment income on its consolidated condensed statement of income. During the quarter ended March 31, 2007, the Company incurred a loss of \$57,000 related to the ineffectiveness of the interest rate swap. The Company does not expect the ineffectiveness related to its hedging activity to be material to the Company's financial results in the future. There were no components of the derivative instruments that were excluded from the assessment of hedge effectiveness. At March 31, 2007, accumulated other comprehensive income included a deferred after-tax net loss of \$2.2 million related to the interest rate swaps. During the quarter ended March 31, 2007, pretax income of \$278,000 (\$181,000 net of tax) was reclassified into interest expense as adjustments to interest payments on variable rate debt. In addition, an amount of \$161,000 (\$105,000 net of tax) was reclassified into earnings from accumulated other comprehensive income associated with the previous termination of the hedging relationship in the fourth quarter of 2006, and the then remaining amount of \$1.6 million accumulated other comprehensive income is expected to be reclassified into earnings in conjunction with the interest payments on the variable rate debt through April 2011.

The Company uses regression analysis to assess the hedge effectiveness in achieving the offsetting cash flows attributable to the risk being hedged. In addition, the Company utilizes the hypothetical derivative methodology for the measurement of ineffectiveness. Derivative gains and losses not effective in hedging the expected cash flows will be recognized immediately in earnings.

**NOTE C FEDERAL INCOME TAXES**

The Company adopted the Financial Accounting Standards Board's Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), effective January 1, 2007. Adoption of this pronouncement did not effect the Company's financial position and no cumulative effect adjustment was required to the January 1, 2007 balance of retained earnings.

As of January 1, 2007, the Company maintained a liability for uncertain tax positions in the amount of \$1.1 million which consists solely of accrued interest related to a tax position that involves the uncertain timing of a deduction claimed on a tax return. Accrued interest and applicable penalties, if any, on uncertain tax positions are recorded as a component of income taxes but is not significant for the quarter ended March 31, 2007. The uncertain tax position is currently under examination and, if resolved favorably, may decrease the Company's effective tax rate within the next 12 months. The years that remain subject to federal tax examination are all years after 2002.



**Table of Contents****NOTE D EARNINGS PER SHARE**

The following table sets forth the computation of basic and diluted earnings per share:

	<b>Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(In thousands, except per share amounts)</b>	
<i>Income available to common shareholders:</i>		
Income from continuing operations	\$ 22,624	\$ 38,846
Income from discontinued operations	67	661
Net income for basic and diluted earnings per share	\$ 22,691	\$ 39,507
Weighted average shares outstanding <sup>3</sup> / <sub>4</sub> basic earnings per share	30,242	46,453
Effect of dilutive securities:		
Employee stock options and other shares	763	811
Weighted average shares outstanding <sup>3</sup> / <sub>4</sub> dilutive earnings per share	31,005	47,264
<i>Basic earnings per share:</i>		
From continuing operations	\$ 0.75	\$ 0.84
From discontinued operations		0.01
Net income	\$ 0.75	\$ 0.85
<i>Diluted earnings per share:</i>		
From continuing operations	\$ 0.73	\$ 0.83
From discontinued operations		0.01
Net income	\$ 0.73	\$ 0.84

As of March 31, 2007, 26,900,160 shares of Class A-1 common stock were issued and outstanding and 3,455,787 shares of Class A-2 common stock were issued, of which 3,454,835 shares were outstanding and 952 shares were held in treasury.

**NOTE E COMMITMENTS AND CONTINGENCIES**

The Company is a party to the following material legal proceedings:

*Association Group Litigation*

The health insurance products issued by the Company's insurance subsidiaries in the self-employed market are primarily issued to members of various membership associations that make available to their members the health insurance and other insurance products issued by the Company's insurance subsidiaries. The associations provide their membership with a number of benefits and products, including the opportunity to apply for health insurance underwritten by the Company's health insurance subsidiaries. As previously disclosed, the Company and/or its insurance company subsidiaries have been named as defendants in numerous cases in California and in other jurisdictions challenging, among other things, the manner in which the defendants market health insurance products in the self-employed market and the nature of the relationship between the Company's insurance companies and the

associations that have made available to their members the insurance companies' health insurance products. Plaintiffs in such cases generally seek injunctive relief and monetary damages in an unspecified amount. Reference is made to the discussion of these cases contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 under the caption "Item 3 Legal Proceedings" and in Note P of Notes to the Company's Consolidated Financial Statements included in such report.

As previously disclosed, HealthMarkets and MEGA were named as defendants in an action filed on October 5, 2005 (*Charles H. Gardner v. MEGA, HealthMarkets, et al*) pending in the Superior Court of Los Angeles County, California (the "California Court"), Case No. BC340625. The plaintiff has asserted violations of the California Consumers Legal Remedies Act, breach of contract, breach of the implied covenant of good faith and fair dealing, fraud, breach of fiduciary duty, negligence and unfair competition. The plaintiff seeks monetary damages in an unspecified amount and injunctive relief. On October 6, 2006, HealthMarkets, MEGA, and HealthMarkets Lead Marketing Group, Inc., filed a motion in the United States District Court for the Northern District of Texas, Dallas Division (the "Texas Court"), to enjoin plaintiff from pursuing claims in this action that were the subject of a previous class action settlement. As part of the previous settlement, the Texas Court barred and permanently enjoined class members from reasserting, in another proceeding, claims that were the subject of the settlement. On

**Table of Contents**

January 4, 2007, the Texas Court granted the defendants' motion and enjoined plaintiff from pursuing claims that were the subject of the previous settlement. On January 16, 2007, the California Court granted MEGA's motion to dismiss these previously-asserted claims. On January 25, 2007, plaintiff appealed the ruling of the Texas Court enjoining plaintiff from pursuing claims that were the subject of the previous settlement. A ruling on the appeal is pending. On March 6, 2007, HealthMarkets and MEGA filed with the California Court a motion to dismiss the balance of plaintiff's claims, which motion was granted on March 27, 2007.

MEGA was named as a defendant in an action filed on August 31, 2006 (*Tracy L. Dobbelaere and Robert Dobbelaere v. The MEGA Life and Health Insurance Company, et al.*) pending in the Circuit Court of Clinton County, Missouri, Cause No. 06CN-CV00618. Plaintiffs have alleged several causes of action including negligence, negligent misrepresentation, intentional misrepresentation, and loss of consortium. Plaintiffs seek unspecified general and punitive damages, interest and attorney's fees. On November 6, 2006, MEGA filed a motion to dismiss, which plaintiffs opposed on December 18, 2006. A ruling on MEGA's motion is pending.

The Company currently believes that resolution of these proceedings will not have a material adverse effect on the Company's consolidated financial condition or results of operations.

*Other Litigation Matters*

The Company and its subsidiaries are parties to various other pending and threatened legal proceedings, claims, demands, disputes and other matters arising in the ordinary course of business, including some asserting significant liabilities arising from claims, demands, disputes and other matters with respect to insurance policies, relationships with agents, relationships with former or current employees, and other matters. From time to time, some such matters, where appropriate, may be the subject of internal investigation by management, the Board of Directors, or a committee of the Board of Directors. The Company currently believes that the liability, if any, resulting from the disposition of such proceedings, claims, demands, disputes or matters would not be material to the Company's financial condition or results of operations.

*Regulatory Matters*

On March 22, 2005, HealthMarkets received notification that the Market Analysis Working Group of the National Association of Insurance Commissioners had chosen the states of Washington and Alaska to lead a multi-state market conduct examination of HealthMarkets' principal insurance subsidiaries. The Company believes that approximately 34 states have elected to participate in the examination, which commenced in May 2005 and is ongoing. The examiners have completed the onsite phases of the examination. An exit interview was held on July 17, 2006, in which representatives of the lead states participated. The Company expects to receive a draft of the examination report in the near future and will respond to the draft report in a timely manner.

The Company's insurance subsidiaries are subject to various other pending market conduct examinations arising in the ordinary course of business. State insurance regulatory agencies have authority to levy monetary fines and penalties and require remedial action resulting from findings made during the course of such market conduct examinations. The Company currently believes that the liability, if any, resulting from the disposition of the multi-state market conduct examination or other market conduct examinations would not be material to the Company's financial condition or results of operations.

**NOTE F – SEGMENT INFORMATION**

The Company's business segments for financial reporting purposes include (i) the Insurance segment (which includes the businesses of the Company's Self-Employed Agency Division (SEA), the Life Insurance Division and Other Insurance); (ii) Other Key Factors (which includes investment income not allocated to the Insurance segment, realized gains or losses on sale of investments, interest expense on corporate debt, general expenses relating to corporate operations, merger transaction expenses, variable non-cash stock-based compensation and operations that do not constitute reportable operating segments); and (iii) Disposed Operations (which includes the Company's former Star HRG Division and former Student Insurance Division).

Allocations of investment income and certain general expenses are based on a number of assumptions and estimates, and the business segments reported operating results would change if different methods were applied. Certain assets are not individually identifiable by segment and, accordingly, have been allocated by formulas. Segment revenues include premiums and other policy charges and considerations, net investment income, fees and



**Table of Contents**

other income. Management does not allocate income taxes to segments. Transactions between reportable operating segments are accounted for under respective agreements, which provide for such transactions generally at cost.

Revenues from continuing operations, income (loss) from continuing operations before federal income taxes, and assets by operating segment are set forth in the tables below:

	<b>Three Months Ended March 31, 2007                      2006 (In thousands)</b>	
<b><i>Revenues from continuing operations:</i></b>		
Insurance:		
Self-Employed Agency Division	\$ 360,240	\$ 363,369
Life Insurance Division	21,554	22,059
Other Insurance	7,626	9,867
Total Insurance	389,420	395,295
Other Key Factors	15,721	14,555
Intersegment Eliminations	(488)	(279)
Total revenues excluding disposed operations	404,653	409,571
Disposed Operations:		
Student Insurance Division		65,099
Star HRG	(32)	38,485
Total Disposed Operations	(32)	103,584
Total revenues	\$ 404,621	\$ 513,155

	<b>Three Months Ended March 31, 2007                      2006 (In thousands)</b>	
<b><i>Income from continuing operations before federal income taxes:</i></b>		
Insurance:		
Self-Employed Agency Division	\$ 35,430	\$ 47,023
Life Insurance Division	29	381
Other Insurance	1,760	1,721
Total Insurance	37,219	49,125
Other Key Factors:		
Investment income on equity, interest expense, realized gains and losses, general corporate expenses and other items	(5,061)	3,928
Merger transaction expenses		(662)
Variable stock-based compensation benefit (expense)	1,551	(240)
Total Other Key Factors	(3,510)	3,026
Total operating income excluding disposed operations	33,709	52,151

Disposed Operations:		
Student Insurance Division	277	4,665
Star HRG Division	79	1,648
Total Disposed Operations	356	6,313
Total income from continuing operations before federal income taxes	\$ 34,065	\$ 58,464

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
	<b>(In thousands)</b>	
<b>Assets:</b>		
Insurance:		
Self-Employed Agency Division	\$ 915,383	\$ 930,856
Life Insurance Division	537,452	552,723
Other Insurance	20,609	20,419
Total Insurance	1,473,444	1,503,998
Other Key Factors	1,003,312	943,360
Total Assets excluding Disposed Operation	2,476,756	2,447,358
Disposed Operations:		
Student Insurance Division	128,285	124,738
Star HRG Division	16,889	16,233
Total Disposed Operations	145,174	140,971
Total assets	\$ 2,621,930	\$ 2,588,329

**Table of Contents**

The Student Insurance Division assets of \$128.3 million at March 31, 2007 represent a reinsurance receivable associated with a coinsurance agreement entered into with an insurance affiliate of UnitedHealth Group, Incorporated. The Star HRG assets of \$16.9 million at March 31, 2007 represent a reinsurance receivable associated with a coinsurance agreement entered into with an insurance affiliate of CIGNA Corporation.

**NOTE G AGENT AND EMPLOYEE STOCK PLANS***Agent Stock Accumulation Plans*

The Company sponsors a series of stock accumulation plans (the Agent Plans) established for the benefit of the independent insurance agents and independent sales representatives associated with UGA Association Field Services, New United Agency, and Cornerstone America.

The Agent Plans generally combine an agent-contribution feature and a Company-match feature. The agent-contribution feature generally provides that eligible participants are permitted to allocate a portion (subject to prescribed limits) of their commissions or other compensation earned on a monthly basis to purchase shares of HealthMarkets Class A-2 common stock at the fair market value of such shares at the time of purchase. Under the Company-match feature of the Agent Plans, participants are eligible to have posted to their respective Agent Plan accounts book credits in the form of equivalent shares based on the number of shares of HealthMarkets Class A-2 common stock purchased by the participant under the agent-contribution feature of the Agent Plans. The matching credits vest over time (generally in prescribed increments over a ten-year period, commencing the plan year following the plan year during which contributions are first made under the agent-contribution feature), and vested matching credits in a participant's plan account in January of each year are converted from book credits to an equivalent number of shares of HealthMarkets common stock. Matching credits forfeited by participants no longer eligible to participate in the Agent Plans are reallocated each year among eligible participants and credited to eligible participants' Agent Plan accounts. Share requirements of the Agent Plans may be met from either unissued or treasury shares.

The Agent Plans do not constitute qualified plans under Section 401(a) of the Internal Revenue Code of 1986 or employee benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA), and the Agent Plans are not subject to the vesting, funding, nondiscrimination and other requirements imposed on such plans by the Internal Revenue Code and ERISA.

For financial reporting purposes, the Company accounts for the Company-match feature of its Agent Plans by recognizing compensation expense over the vesting period in an amount equal to the fair market value of vested shares at the date of their vesting and distribution to the participants. The Company estimates its current liability for unvested matching credits by reference to the number of unvested credits, the prevailing fair market value (as determined by the Company's Board of Directors) of the Company's common stock, and the Company's estimate of the percentage of the vesting period that has elapsed up to the current quarter end. Changes in the liability from one quarter to the next are accounted for as an increase in, or decrease to, compensation expense, as the case may be. Upon vesting, the Company reduces the accrued liability (equal to the market value of the vested shares at date of vesting) with a corresponding increase to equity. Unvested matching credits are considered share equivalents outstanding for purposes of the computation of earnings per share.

The portion of compensation expense associated with the Agent Plans reflected in the results of the SEA Division is based on the prevailing fair value of Class A-2 common stock (as determined by the Board of Directors of the Company since the Merger or, prior to the Merger, by reference to the fair value of the Company's common stock) on or about the time the unvested matching credits are granted to participants. In accordance with the terms of the Agent Plans, the Board of Directors of the Company establishes the fair market value of Class A-2 common stock on a quarterly basis. The remaining portion of the compensation expense associated with the Agent Plans (consisting of variable stock-based compensation expense) is reflected in the results of the Company's Other Key Factors business segment.

Set forth in the table below is the total compensation expense and tax benefit associated with the Company's Agent Plans for the three months ended March 31, 2007 and 2006:

**Table of Contents**

	<b>Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(In thousands)</b>	
SEA Division stock-based compensation expense (1)	\$ 4,620	\$ 2,505
Other Key Factors variable non-cash stock-based compensation (benefit) expense (2)	(1,551)	240
Total Agent Plan compensation expense	3,069	2,745
Related Tax Benefit	1,074	961
Net Amount included in financial results	\$ 1,995	\$ 1,784

(1) Represents the cost of Class A-2 common stock (determined by reference to the prevailing fair value of Class A-2 common stock as determined by the Board of Directors of the Company or, prior to the Merger, by reference to the market price of HealthMarkets common shares) on or about the time that unvested matching credits are granted to participants in the Agent Plan. This amount is reflected in the caption Underwriting, policy acquisition costs, and



insurance  
expenses on the  
Company's  
Consolidated  
Condensed  
Statement of  
Operations.

- (2) Represents the  
total  
stock-based  
compensation  
expense  
associated with  
the Agent Plans  
less the expense  
incurred by the  
Company on or  
about the time  
that unvested  
matching credits  
are granted to  
participants in  
the Agent Plan.  
This amount is  
reflected in the  
caption Variable  
stock  
compensation  
expense on the  
Company's  
Consolidated  
Condensed  
Statement of  
Operations.

At December 31, 2006, the Company had recorded 1,373,456 unvested matching credits associated with the Agent Plans, of which 423,145 vested in January 2007. Upon vesting, the Company increased additional paid-in capital by \$17.3 million, decreased treasury shares by \$3.9 million and decreased other liabilities by \$21.2 million. At March 31, 2007, the Company had recorded 1,050,569 unvested matching credits.

Agent Plan transactions are not reflected in the Consolidated Condensed Statement of Cash Flows because issuance of equity securities to settle the Company's liabilities under the Agent Plans are non-cash transactions.

*Employee Stock Option Plans*

At an Executive Compensation Committee meeting held on March 29, 2007, the Committee approved the granting of 158,150 options to purchase shares of Class A-1 common stock. Of the 158,150 options approved, 154,150 were granted at an exercise price of \$50.00 per share, which represented the fair value of Class A-1 common stock as determined by the Board of Directors on the date of grant of such options, and 4,000 were granted at an exercise price of \$50.73 per share, which represented the fair value of Class A-1 common stock as determined by the Board of Directors on the date of grant of such options.

**Table of Contents**

Set forth below is a summary of stock option transactions including certain information with respect to the Performance-Based Options for which no performance goals have been established:

	<b>Options Outstanding for Accounting (Excludes Options with no Performance Criteria)</b>		<b>Performance-Based Options with No Performance Based Goals Established</b>		<b>Combined Total</b>
	<b>Number</b>	<b>Average Option Price</b>	<b>Number</b>	<b>Average Option Price</b>	
	<b>Of</b>	<b>per Share</b>	<b>Of</b>	<b>per Share</b>	<b>Of</b>
	<b>Shares</b>	<b>(\$)</b>	<b>Shares</b>	<b>(\$)</b>	<b>Shares</b>
Outstanding options at January 1, 2007	991,113	34.96	268,002	37.54	1,259,115
Granted (a)	102,768	50.00	51,382	50.00	154,150
Expired					
Cancelled	(1,875)	38.37	(625)	38.37	(2,500)
Exercised	(2,703)	9.25			(2,703)
Outstanding options at March 31, 2007	1,089,303	36.43	318,759	39.55	1,408,062
Options exercisable at March 31, 2007	95,160	9.25			95,160

(a) Excludes 4,000 options approved by the Executive Compensation Committee on March 29, 2007 for an individual whose employment commenced in April, 2007.

**NOTE H TRANSACTIONS WITH RELATED PARTIES**

On April 5, 2006, the Company completed its Merger and as a result, affiliates of The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners (the Private Equity Investors ) held, as of the effective date of the Merger, approximately 55.3%, 22.7% and 11.3%, respectively, of the Company's outstanding equity securities. At March 31, 2007, affiliates of The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners held approximately 54.3%, 22.3% and 11.1%, respectively, of the Company's outstanding equity securities. Certain members of the Board of Directors of the Company are affiliated with The Private Equity Investors; in particular, Chinh E. Chu and Matthew Kabaker serve as Senior Managing Director and a Principal, respectively, of

The Blackstone Group, Adrian M. Jones and Nathaniel Zilkha serve as a Managing Director and Vice President, respectively, of Goldman, Sachs & Co., and Kamil M. Salame is a partner of DLJ Merchant Banking Partners.

In accordance with the terms of Transaction and Monitoring Fee Agreements with advisory affiliates of each of the Private Equity Investors, the advisory affiliates of each of the Private Equity Investors agreed to provide to the Company ongoing monitoring, advisory and consulting services, for which the Company agreed to pay to affiliates of each of The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners an annual monitoring fee in an amount equal to \$7.7 million, \$3.5 million and \$1.3 million, respectively. The annual monitoring fees are in each case subject to upward adjustment in each year based on the ratio of the Company's consolidated earnings before interest, taxes, depreciation and amortization (EBITDA) in such year to consolidated EBITDA in the prior year, provided that the aggregate monitoring fees paid to all advisors pursuant to the Transaction and Monitoring Fee Agreements in any year shall not exceed the greater of \$15.0 million or 3% of consolidated EBITDA in such year. The aggregate annual monitoring fees in the amount of \$12.5 million payable with respect to 2007 were paid in full to the advisory affiliates of the Private Equity Investors on January 3, 2007. The Company has expensed \$3.1 million through March 31, 2007.

Pursuant to the terms of an advisory agreement, dated August 18, 2006, The Blackstone Group agreed to provide certain financial and mergers and acquisition advisory services to MEGA in connection with the sale by MEGA of MEGA's STAR HRG and Student Insurance operations. Pursuant to the terms of an amendment, dated December 29, 2006, to the advisory agreement, The Blackstone Group provided certain tax structuring advisory services to MEGA in connection with the sale by MEGA of MEGA's Student Insurance operations, for which MEGA paid to an advisory affiliate of The Blackstone Group on February 16, 2007, a tax structuring fee in the amount of \$1.0 million.

**Table of Contents**

NOTE I SUBSEQUENT EVENT SPECIAL DIVIDEND

On May 3, 2007, the Company's Board of Directors declared a special dividend in the amount of \$10.51 per share for Class A-1 and Class A-2 common stock to holders of record as of close of business on May 9, 2007, payable on May 14, 2007.

17

---

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Introduction**

The Company's business segments for financial reporting purposes include (i) the Insurance segment (which includes the businesses of the Company's Self-Employed Agency Division (SEA), the Life Insurance Division and Other Insurance); (ii) Other Key Factors (which includes investment income not allocated to the Insurance segment, realized gains or losses on sale of investments, interest expense on corporate debt, general expenses relating to corporate operations, merger transaction expenses, variable non-cash stock-based compensation and operations that do not constitute reportable operating segments); and (iii) Disposed Operations (which includes the Company's former Star HRG Division and former Student Insurance Division).

**Results of Operations**

The table below sets forth certain summary information about the Company's operating results for the three months ended March 31, 2007 and 2006:

	<b>Three Months Ended March 31, 2007</b>	<b>2006</b>	<b>Percentage Increase (Decrease)</b>
	<b>(Dollars in thousands)</b>		
Revenue:			
Premiums:			
Health	\$ 333,762	\$ 442,550	-24.6%
Life premiums and other considerations	16,381	16,139	1.5%
Total premium	350,143	458,689	-23.7%
Investment income	26,460	27,158	-2.6%
Other income	25,615	25,133	1.9%
Gains on sale of investments	2,403	2,175	10.5%
Total revenues	404,621	513,155	-21.2%
Benefits and Expenses			
Benefits, claims, and settlement expenses	215,331	272,725	-21.0%
Underwriting, policy acquisition costs, and insurance expenses	121,998	155,407	-21.5%
Variable stock compensation (benefit) expense	(1,551)	240	NM
Other expenses	21,782	24,539	-11.2%
Interest expense	12,996	1,780	NM
Total expenses	370,556	454,691	-18.5%
Income from continuing operations before income taxes	34,065	58,464	-41.7%
Federal income taxes	11,441	19,618	-41.7%
Income from continuing operations	22,624	38,846	-41.8%
Income from discontinued operations (net of income tax)	67	661	-89.9%
Net income	\$ 22,691	\$ 39,507	-42.6%

NM: not  
meaningful



**Table of Contents**

Revenues and income from continuing operations before federal income taxes ( operating income ) by business segment are summarized in the tables below:

	<b>Three Months Ended March 31, 2007                  2006 (In thousands)</b>	
<i>Revenues from continuing operations:</i>		
Insurance:		
Self-Employed Agency Division	\$ 360,240	\$ 363,369
Life Insurance Division	21,554	22,059
Other Insurance	7,626	9,867
 Total Insurance	 389,420	 395,295
Other Key Factors	15,721	14,555
Intersegment Eliminations	(488)	(279)
 Total revenues excluding disposed operations	 404,653	 409,571
Disposed Operations:		
Student Insurance Division		65,099
Star HRG	(32)	38,485
 Total Disposed Operations	 (32)	 103,584
 Total revenues	 \$ 404,621	 \$ 513,155

	<b>Three Months Ended March 31, 2007                  2006 (In thousands)</b>	
<i>Income from continuing operations before federal income taxes:</i>		
Insurance:		
Self-Employed Agency Division	\$ 35,430	\$ 47,023
Life Insurance Division	29	381
Other Insurance	1,760	1,721
 Total Insurance	 37,219	 49,125
Other Key Factors:		
Investment income on equity, realized gains and losses, interest expense, general corporate expenses and other	(5,061)	3,928
Merger transaction expenses		(662)
Variable stock-based compensation benefit(expense)	1,551	(240)
 Total Other Key Factors	 (3,510)	 3,026
 Total operating income excluding disposed operations	 33,709	 52,151
Disposed Operations:		

Edgar Filing: HealthMarkets, Inc. - Form 10-Q

Student Insurance Division	277	4,665
Star HRG Division	79	1,648
Total Disposed Operations	356	6,313
Total income from continuing operations before federal income taxes	\$ 34,065	\$ 58,464



**Table of Contents**

HealthMarkets' results of operations for the three months ended March 31, 2007 were particularly impacted by the following factors:

*Self-Employed Agency Division*

Set forth below is certain summary financial and operating data for the Company's Self-Employed Agency (SEA) Division for the three months ended March 31, 2007 and 2006:

	<b>Self-Employed Agency Division</b>		
	<b>Three Months Ended</b>		<b>Percentage</b>
	<b>March 31,</b>		<b>Increase</b>
	<b>2007</b>	<b>2006</b>	<b>(Decrease)</b>
	<b>(Dollars in thousands)</b>		
Revenue:			
Earned premium revenue	\$ 326,657	\$ 331,765	-1.5%
Investment income (1)	7,909	7,910	0%
Other income	25,674	23,694	8.4%
<b>Total revenues</b>	<b>360,240</b>	<b>363,369</b>	<b>-0.9%</b>
Expenses:			
Benefit expenses	198,608	186,483	6.5%
Underwriting and policy acquisition expenses (1)	112,077	114,860	-2.4%
Other expenses	14,125	15,003	-5.9%
<b>Total expenses</b>	<b>324,810</b>	<b>316,346</b>	<b>2.7%</b>
<b>Operating income</b>	<b>\$ 35,430</b>	<b>\$ 47,023</b>	<b>-24.7%</b>
<i>Other operating data:</i>			
Loss ratio (2)	60.8%	56.2%	
Expense ratio (3)	34.3%	34.6%	
<b>Combined ratio</b>	<b>95.1%</b>	<b>90.8%</b>	
Average number of writing agents in period	2,103	2,176	
Submitted annualized volume (4)	\$ 200,623	\$ 213,545	

(1) Allocations of investment income and certain general expenses are based on a number of assumptions and estimates, and the business divisions reported operating results

would change if different methods were applied.

- (2) Defined as total benefit expenses as a percentage of earned premium revenue.
- (3) Defined as total underwriting and policy acquisition expenses as a percentage of earned premium revenue.
- (4) Submitted annualized premium volume in any period is the aggregate annualized premium amount associated with health insurance applications submitted by the Company's agents in such period for underwriting by the Company.

The SEA Division reported operating income in the three month period ended March 31, 2007 of \$35.4 million, compared to operating income of \$47.0 million in the corresponding 2006 period. The decrease in operating income in the three-month period ended March 31, 2007 was primarily due to an increase in the loss ratio (from 56.2% in the 2006 three-month period to 60.8% in the 2007 three-month period).

Operating income at the SEA Division as a percentage of earned premium revenue (*i.e.*, operating margin) in the three month period ended March 31, 2007 was 10.8%, compared to operating margin of 14.2% in the corresponding 2006 period. The decrease in operating margin is attributable primarily to the period-over-period increase in the loss ratio as a result of a product mix shift to new health insurance products in the Company's recently introduced CareOne product suite (which provide a higher proportion of the premium as benefits) and cost containment expenses resulting from the Company's initiatives to control medical costs, the benefits of which have not yet been fully realized.

In the three months ended March 31, 2007, total SEA Division submitted annualized premium volume (*i.e.*, the aggregate annualized premium amount associated with individual and small group health insurance applications

submitted by the Company's agents for underwriting by the Company) decreased to \$200.6 million, from \$213.5 million in the corresponding 2006 period. The period-over-period decrease in submitted annualized premium volume was attributable primarily to a decrease in the average number of writing agents in the field from 2,176 for the three months ended March 31, 2006 to 2,103 for the three months ended March 31, 2007 and a 6.3% decrease in

**Table of Contents**

the weekly applications submitted per writing agent. This was partially offset by a 5% increase in the average premium per policy in the first quarter of 2007 compared to the comparable period in 2006.

The Company is in the process of implementing several new initiatives established to increase the average number of writing agents and agent productivity through the use of new commission incentive programs, new products and geographic expansion.

*Life Insurance Division*

Set forth below is certain summary financial and operating data for the Company's Life Insurance Division for the three months ended March 31, 2007 and 2006:

	<b>Life Insurance Division</b>		
	<b>Three Months Ended</b>		<b>Percentage</b>
	<b>March 31,</b>		<b>Increase</b>
	<b>2007</b>	<b>2006</b>	<b>(Decrease)</b>
	<b>(Dollars in thousands)</b>		
Revenue:			
Earned premium revenue	\$ 16,270	\$ 16,201	0.4%
Investment income (1)	5,089	5,085	0.1%
Other income	195	773	-74.8%
Total revenues	21,554	22,059	-2.3%
Expenses:			
Benefit expenses	13,879	11,882	16.8%
Underwriting and acquisition expenses (1)	7,646	9,796	-21.9%
Total expenses	21,525	21,678	-0.7%
Operating income	\$ 29	\$ 381	-92.4%

(1) Allocations of investment income and certain general expenses are based on a number of assumptions and estimates, and the business division's reported operating results would change if different methods were applied.

The Company's Life Insurance Division reported operating income in the three month period ended March 31, 2007 of \$29,000, compared to operating income of \$381,000 in the corresponding 2006 period. The decrease in operating income for the three month period ended March 31, 2007 compared to the corresponding 2006 period was primarily

attributable to a \$2.0 million increase in death claims during the first quarter of 2007 partially offset by a decrease in administrative expenses and a decrease in the amortization of deferred acquisition costs. The decrease in amortization of deferred acquisition costs in the 2007 period is associated with the conversion to a new actuarial reserving software. Partially offsetting the decrease in amortization of deferred acquisition costs was an increase in unearned premium liability which decreased premium revenue. The increase to the unearned premium liability is also associated with the conversion to the new actuarial software.

In the three months ended March 31, 2007, the Company's Life Insurance Division generated annualized paid premium volume (i.e., the aggregate annualized life premium amount associated with new life insurance policies issued by the Company) in the amount of \$4.2 million, compared to \$5.7 million in the corresponding 2006 period. The first quarter 2007 decrease in annualized premium was primarily due to a reduction of certain agents based on placement levels or business placed with substandard persistency or mortality

However, the first quarter 2007 annualized paid premium volume of \$4.2 million is 18% higher than the fourth quarter 2006 annualized paid premium volume of \$3.6 million primarily due to product, bonus, underwriting and business processing enhancements initiated in December 2006 that are being positively received by the distribution channels.

**Table of Contents***Other Insurance*

Set forth below is certain summary financial and operating data for the Company's Other Insurance division for the three months ended March 31, 2007 and 2006:

	<b>Other Insurance Division</b>		
	<b>Three Months</b>		<b>Percentage</b>
	<b>Ended</b>		<b>Increase</b>
	<b>March 31,</b>		<b>(Decrease)</b>
	<b>2007</b>	<b>2006</b>	<b>(Decrease)</b>
	<b>(Dollars in thousands)</b>		
Revenue:			
Earned premium revenue	\$ 7,248	\$ 9,538	-24.0%
Investment income (1)	360	296	21.6%
Other income	18	33	-45.5%
Total revenues	7,626	9,867	-22.7%
Expenses:			
Benefit expenses	3,175	5,195	-38.9%
Underwriting and policy acquisition expenses (1)	2,691	2,951	-8.8%
Total expenses	5,866	8,146	-28.0%
Operating income	\$ 1,760	\$ 1,721	2.3%
<i>Other operating data:</i>			
Loss ratio (2)	43.8%	54.5%	
Expense ratio (3)	37.1%	30.9%	
Combined ratio	80.9%	85.4%	

(1) Allocations of investment income and certain general expenses are based on a number of assumptions and estimates, and the business division's reported operating results would change if different methods were applied.

- (2) The loss ratio represents benefits, claims and settlement expenses related to accident insurance and reinsurance contracts stated as a percentage of earned premiums. The expense ratio represents underwriting, contract acquisition costs and expenses related to accident insurance and reinsurance contracts stated as a percentage of earned premiums.
- (3) Operating margin is defined as operating income as a percentage of earned premium revenue.

The Other Insurance division consists of the operations of ZON Re USA LLC (an 82.5%-owned subsidiary), which underwrites, administers and issues accidental death, accidental death and dismemberment (AD&D), accident medical and accident disability insurance products, both on a primary and on a reinsurance basis. The decrease in the revenue is due to lower sales for the current year related to increased competitive pressure. The decrease in the loss ratio from 54.5% for the three months ended March 31, 2006 to 43.8% for the three months ended March 31, 2007 is due to the better than anticipated experience on some contracts expiring during the period.

**Table of Contents***Other Key Factors*

The Company's Other Key Factors segment includes investment income not otherwise allocated to the Insurance segment, realized gains and losses, interest expense on corporate debt, general expenses relating to corporate operations, merger transaction expenses, variable stock compensation, and other unallocated items.

Set forth below is certain summary financial data for the Company's Other Key Factors segment for the three months ended March 31, 2007 and 2006:

	<b>Other Key Factors</b>		
	<b>Three Months Ended</b>		<b>Percentage</b>
	<b>March 31,</b>		<b>Increase</b>
	<b>2007</b>	<b>2006</b>	<b>(Decrease)</b>
	<b>(Dollars in thousands)</b>		
Investment income on equity	\$ 11,105	\$ 9,836	12.9%
Realized gain on investments	2,403	2,175	10.5%
Merger transaction expenses		(662)	
Interest expense on non-student loan debt	(11,455)	(332)	NA
Variable stock-based compensation benefit (expense)	1,551	(240)	NA
General corporate expenses and other	(7,114)	(7,751)	8.2%
Operating (expense) income	\$ (3,510)	\$ 3,026	-216.0%

The Other Key Factors segment reported an operating loss in the three month period ended March 31, 2007 of \$(3.5) million, compared to operating income of \$3.0 million in the corresponding 2006 period.

The decrease in income is due to interest expense in the 2007 period associated with the Merger-related indebtedness partially offset by an increase in investment income on equity. During the first quarter of 2007, the Company had debt outstanding of \$556.1 million compared to \$15.5 million during the first quarter of 2006. *See* Note B of Notes to Consolidated Condensed Financial Statements (Unaudited).

**Liquidity and Capital Resources**

Historically, the Company's primary sources of cash on a consolidated basis have been premium revenues from policies issued, investment income, fees and other income, and borrowings under a secured student loan credit facility. The primary uses of cash have been payments for benefits, claims and commissions under those policies, servicing of the Company's debt obligations, operating expenses and the funding of student loans generated under the Company's College First Alternative Loan program. In the three months ended March 31, 2007, net cash provided by operations totaled approximately \$23.2 million, compared to \$86.3 million in the corresponding period of 2006.

HealthMarkets, Inc., is a holding company, the principal assets of which are its investment in its wholly-owned subsidiary, HealthMarkets, LLC, to which, in connection with the Merger, HealthMarkets, Inc. contributed substantially all of its assets and liabilities. The holding company's ability to fund its cash requirements is largely dependent upon its ability to access cash, by means of dividends or other means, from HealthMarkets, LLC. HealthMarkets, LLC's principal assets are its investments in its separate operating subsidiaries, including its regulated insurance subsidiaries. The agreements governing certain indebtedness incurred by the Company in connection to the Merger contain restrictive covenants, including certain prescribed financial ratios, limitations on additional indebtedness as a percentage of certain defined equity amounts and restrictions on the disposal of certain subsidiaries, including primarily the Company's regulated insurance subsidiaries.

At March 31, 2007 and December 31, 2006, the aggregate cash and cash equivalents and short-term investments held at both the holding company level and HealthMarkets, LLC was \$382.1 million and \$311.5 million, respectively.

Prior approval by insurance regulatory authorities is required for the payment by a domestic insurance company of dividends that exceed certain limitations based on statutory surplus and net income. During 2007 (through May 11, 2007), the Company's domestic insurance subsidiaries declared and paid dividends to HealthMarkets, LLC in the amount of \$122.2 million, including an extraordinary dividend in the amount of \$100.0 million. The





**Table of Contents**

extraordinary dividend resulted in the liquidation of approximately \$83.6 million of fixed maturities. The remaining amount of ordinary dividends in calendar year 2007 that could be paid by the Company's domestic insurance subsidiaries to HealthMarkets, LLC is approximately \$49.0 million. As it has done in the past, the Company will continue to assess the results of operations of the regulated domestic insurance subsidiaries to determine the prudent dividend capability of the subsidiaries, consistent with HealthMarkets' practice of maintaining risk-based capital ratios at each of the Company's domestic insurance subsidiaries significantly in excess of minimum requirements. The agreements governing certain indebtedness incurred by the Company in connection with the Merger contain restrictive covenants, including certain prescribed financial ratios, limitations on additional indebtedness as a percentage of certain defined equity amounts and restrictions on the disposal of certain subsidiaries, including primarily the Company's regulated insurance subsidiaries.

**Contractual Obligations and Off Balance Sheet Obligations**

The agreements governing certain indebtedness incurred by the Company in connection with the Merger contain restrictive covenants, including certain prescribed financial ratios, limitations on additional indebtedness as a percentage of certain defined equity amounts and restrictions on the disposal of certain subsidiaries, including primarily the Company's regulated insurance subsidiaries. Other contractual obligations or off balance sheet arrangements (which consist solely of commitments to fund student loans generated by its former College Fund Life Division and letters of credit) are described in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations.

Set forth below is a summary of the Company's contractual obligations (on a consolidated basis) at March 31, 2007 and December 31, 2006 (dollars in thousands):

	<b>At March 31, 2007</b>	<b>At December 31, 2006</b>
Corporate indebtedness	\$ 556,070	\$ 556,070
Student loan credit facility	116,700	118,950
Future policy benefits	456,865	453,715
Claim liabilities	532,227	517,132
Capital lease obligations	1,304	1,624
<b>Total</b>	<b>\$ 1,663,166</b>	<b>\$ 1,647,491</b>

In addition to the contractual obligations set forth in the table above, the Company also is a party to various operating leases for office space and equipment.

All indebtedness issued under the secured student loan credit facility represents obligations solely of a special purpose entity (SPE) and not of the Company or any other subsidiary and is secured by student loans, accrued investment income, cash, cash equivalents and qualified investments.

At each of March 31, 2007 and December 31, 2006, the Company had \$9.6 million of letters of credit outstanding relating to its insurance operations.

**Critical Accounting Policies and Estimates**

The Company's discussion and analysis of its financial condition and results of operations are based upon its consolidated condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated condensed financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to health and life insurance claims and liabilities, deferred acquisition costs, bad debts, impairment of investments, intangible assets, income taxes, financing operations and contingencies and litigation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making

judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Reference is made to the discussion of these critical accounting policies and estimates contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations *Critical Accounting Policies and Estimates*.

**Table of Contents**

**Regulatory and Legislative Matters**

The business of insurance is primarily regulated by the states and is also affected by a range of legislative developments at the state and federal levels. Recently adopted legislation and regulations may have a significant impact on the Company's business and future results of operations. Reference is made to the discussion under the caption "Business Regulatory and Legislative Matters" in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

**SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995:**

Some of the matters discussed in this Quarterly Report on Form 10-Q may contain forward-looking statements that are subject to certain risks, uncertainties and assumptions. Such forward-looking statements are intended to be identified in this document by the words "anticipate", "believe", "estimate", "expect", "intend", "objective", "plan", "potential" and similar expressions. Actual results may vary materially from those included in the forward-looking statements. Factors that could cause actual results to differ materially from those included in the forward-looking statements include, but are not limited to, the following:

general economic conditions;

the continued ability of the Company to compete for customers and insureds in an industry where many of its competitors may have greater market share and/or greater financial resources;

the Company's ability to accurately estimate medical claims and control costs;

changes in government regulation that could increase the costs of compliance or cause the Company to discontinue marketing its products in certain states;

the Company's failure to comply with new or existing government regulation that could subject it to significant fines and penalties;

changes in the relationship between the Company and the membership associations that make available to their members the health insurance and other insurance products issued by the Company's insurance subsidiaries;

changes in the laws and regulations governing so-called "association group" insurance (particularly changes that would subject the issuance of policies to prior premium rate approval and/or require the issuance of policies on a "guaranteed issue" basis);

significant liabilities and costs associated with litigation;

failure of the Company's information systems to provide timely and accurate information;

negative publicity regarding the Company's business practices and/or regarding the health insurance industry in general;

the Company's inability to enter into or maintain satisfactory relationships with networks of hospitals, physicians, dentists, pharmacies and other health care providers;

failure of the Company's regulated insurance company subsidiaries to maintain their current ratings by A.M. Best Company, Fitch and/or Standard & Poor's;

the other risk factors set forth in the reports filed by the Company from time to time with the Securities and Exchange Commission.

Reference is made to the discussion of these and other risk factors contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 under the caption "Management's Discussion and Analysis of

**Table of Contents**

Financial Condition and Results of Operations *Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995.*

**ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company has not experienced significant changes related to its market risk exposures during the quarter ended March 31, 2007. Reference is made to the information contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 in Item 7A *Quantitative and Qualitative Disclosures about Market Risk.*

**ITEM 4 CONTROLS AND PROCEDURES**

**Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

**Change in Internal Control over Financial Reporting**

There has been no change in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1 LEGAL PROCEEDINGS**

The Company is a party to various material legal proceedings, which are described in Note E of Notes to the Consolidated Condensed Financial Statements included herein and/or in the Company's Annual Report on Form 10-K filed for the year ended December 31, 2006 under the caption Item 3 - Legal Proceedings. The Company and its subsidiaries are parties to various other pending legal proceedings arising in the ordinary course of business, including some asserting significant damages arising from claims under insurance policies, disputes with agents and other matters. Based in part upon the opinion of counsel as to the ultimate disposition of such lawsuits and claims, management believes that the liability, if any, resulting from the disposition of such proceedings will not be material to the Company's consolidated financial condition or results of operations. Except as discussed in Note E to Notes to the Company's Consolidated Condensed Financial Statements included herein, during the fiscal quarter covered by this Quarterly Report on Form 10-Q, the Company has not been named in any new material legal proceeding, and there have been no material developments in the previously reported legal proceedings.

**ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

During the three months ended March 31, 2007, the Company issued an aggregate of 8,000 unregistered shares of its Class A-1 common stock to a newly-appointed executive officer of the Company. In particular, on March 30, 2007, an executive officer of the Company purchased 8,000 shares of the Company's Class A-1 common stock for aggregate consideration of \$400,000 (or \$50 per share). Such sale of securities was made in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended (and/or Regulation D promulgated thereunder) for transactions by an issuer not involving a public offering. The proceeds of such sale were used for general corporate purposes.

The following table sets forth the Company's purchases of HealthMarkets, Inc. Class A-2 common stock during each of the months in the three-month period ended March 31, 2007, pursuant to the terms of the Company's agent stock accumulation plans established for the benefit of the Company's agents (*See* Note G of the Notes to Consolidated Condensed Financial Statements):

<b>Period</b>	<b>Total Number of Shares Purchased<sup>(1)</sup></b>	<b>Average Price Paid per Share (\$)</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number of Shares That May Yet Be Purchased Under The Plan or Program</b>
1/1/07-1/31/07	952	39.66		
2/1/07-2/28/07				
3/1/07-3/31/07				
<b>Totals</b>	952	39.66		

(1) The number of shares purchased other than through a publicly announced plan or program includes 952 shares

purchased with  
respect to the  
stock  
accumulation  
plans  
established for  
the benefit of  
Company's  
agents.

27

---



**Table of Contents**

ITEM 6 EXHIBITS

(a) Exhibits.

<b>Exhibit No.</b>	<b>Description</b>
31.1	Rule 13a-14(a)/15d-14(a) Certification, executed by William J. Gedwed, President and Chief Executive Officer of HealthMarkets, Inc.
31.2	Rule 13a-14(a)/15d-14(a) Certification, executed by Michael E. Boxer, Executive Vice President and Chief Financial Officer of HealthMarkets, Inc.
32	Certifications required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350), executed by William J. Gedwed, President and Chief Executive Officer of HealthMarkets, Inc. and Michael E. Boxer, Executive Vice President and Chief Financial Officer of HealthMarkets, Inc.

**Table of Contents**

**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.

Date: May 14, 2007

HealthMarkets, Inc.  
(Registrant)

/s/ William J. Gedwed

William J. Gedwed, President, Chief  
Executive  
Officer and Director

Date: May 14, 2007

/s/ Michael E. Boxer

Michael E. Boxer, Executive Vice  
President  
and Chief Financial Officer