

FIRST MERCURY FINANCIAL CORP

Form 10-Q

August 08, 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 June 30, 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 Number 001-33077

FIRST MERCURY FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or
organization)

38-3164336

(I.R.S. Employer Identification No.)

29110 Inkster Road

Suite 100

Southfield, Michigan

(Address of Principal Executive Offices)

48034

(Zip Code)

Registrant's telephone number, including area code: (800) 762-6837

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 issuer's class of common stock, as of the latest practicable date.

The number of shares of Common Stock, par value \$0.01, outstanding on August 3, 2007 was 18,036,168.

TABLE OF CONTENTS

Item		Page
	<u>PART I FINANCIAL INFORMATION</u>	
1.	<u>Condensed Consolidated Financial Statements</u>	
	<u>Condensed Consolidated Balance Sheets</u>	3
	<u>Condensed Consolidated Statements of Income</u>	4
	<u>Condensed Consolidated Statements of Stockholders' Equity</u>	5
	<u>Condensed Consolidated Statements of Cash Flows</u>	6
	<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	7
2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	31
4.	<u>Controls and Procedures</u>	31
	<u>PART II OTHER INFORMATION</u>	
4.	<u>Submission of Matters to a Vote of Security Holders</u>	32
6.	<u>Exhibits</u>	32
	<u>Certification of Chief Executive Officer</u>	
	<u>Certification of Chief Financial Officer</u>	
	<u>1350 Certification of Chief Executive Officer</u>	
	<u>1350 Certification of Chief Financial Officer</u>	

Table of Contents**FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES****PART I. FINANCIAL INFORMATION****ITEM 1. Condensed Consolidated Financial Statements****Condensed Consolidated Balance Sheets**

	June 30, 2007 (Unaudited)	December 31, 2006
	(Dollars in thousands, except share data)	
ASSETS		
Investments		
Debt securities	\$ 327,208	\$ 260,323
Equity securities and other	4,135	3,184
Short-term	64,511	34,334
Total Investments	395,854	297,841
Cash and cash equivalents	7,071	14,335
Premiums and reinsurance balances receivable	32,751	46,090
Accrued investment income	3,831	2,931
Accrued profit sharing commissions	9,538	7,735
Reinsurance recoverable on paid and unpaid losses	79,495	69,437
Prepaid reinsurance premiums	42,770	10,377
Deferred acquisition costs	12,489	18,452
Deferred federal income taxes	1,869	
Intangible assets, net of accumulated amortization	37,264	37,878
Other assets	9,663	7,857
Total Assets	\$ 632,595	\$ 512,933
LIABILITIES AND STOCKHOLDERS' EQUITY		
Loss and loss adjustment expense reserves	\$ 235,862	\$ 191,013
Unearned premium reserves	116,702	91,803
Long-term debt	46,394	46,394
Funds held under reinsurance treaties	19,268	
Reinsurance payable on paid losses	4,827	2,877
Premiums payable to insurance companies	1,782	728
Deferred federal income taxes		1,642
Accounts payable, accrued expenses, and other liabilities	3,367	5,738
Total Liabilities	428,202	340,195
Stockholders' Equity		
Common stock, \$0.01 par value; authorized 100,000,000 shares; issued and outstanding 18,036,168 and 17,330,831 shares	181	174
Paid-in-capital	166,353	153,600
Accumulated other comprehensive loss	(2,469)	(761)

Edgar Filing: FIRST MERCURY FINANCIAL CORP - Form 10-Q

Retained earnings	40,926	20,323
Treasury stock; 92,500 shares	(598)	(598)
Total Stockholders' Equity	204,393	172,738
Total Liabilities and Stockholders' Equity	\$ 632,595	\$ 512,933

See accompanying notes to condensed consolidated financial statements.

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Income
(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
	(Dollars in thousands, except share and per share data)			
Operating Revenue				
Net earned premiums	\$ 43,571	\$ 28,328	\$ 88,500	\$ 56,857
Commissions and fees	4,902	4,319	9,559	8,763
Net investment income	3,870	2,121	7,164	4,271
Net realized gains (losses) on investments	627	(329)	762	(482)
Total Operating Revenues	52,970	34,439	105,985	69,409
Operating Expenses				
Losses and loss adjustment expenses, net	22,488	15,055	46,442	29,962
Amortization of deferred acquisition expenses	7,557	4,198	16,296	9,092
Underwriting, agency and other expenses	5,613	3,169	9,344	7,379
Amortization of intangible assets	307	291	613	583
Total Operating Expenses	35,965	22,713	72,695	47,016
Operating Income	17,005	11,726	33,290	22,393
Interest Expense	986	2,747	1,968	5,395
Change in Fair Value of Derivative Instruments	(127)	(157)	(19)	(386)
Income Before Income Taxes	16,146	9,136	31,341	17,384
Income Taxes	5,642	3,170	10,871	6,039
Net Income	\$ 10,504	\$ 5,966	\$ 20,470	\$ 11,345
Net Income Per Share:				
Basic	\$ 0.60	\$ 1.20	\$ 1.18	\$ 2.26
Diluted	\$ 0.58	\$ 0.48	\$ 1.12	\$ 0.92

Weighted Average Shares Outstanding:

Edgar Filing: FIRST MERCURY FINANCIAL CORP - Form 10-Q

Basic	17,428,006	4,216,144	17,380,219	4,216,144
Diluted	18,254,015	12,467,938	18,220,558	12,324,179

See accompanying notes to condensed consolidated financial statements.

4

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Stockholders' Equity
(Unaudited)

	Common	Convertible Preferred	Paid-in	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total
	Stock	Stock	Capital				
	(Dollars in thousands, except share data)						
Balance, January 1, 2006	\$ 42	\$	\$ 58,857	\$ (1,284)	\$ 6,712	\$	\$ 64,327
Issuance of stock			243				243
Comprehensive income:							
Net income					11,345		11,345
Other comprehensive loss, net of tax							
Unrealized holding losses on securities arising during the period				(1,956)			(1,956)
Less reclassification adjustment for losses included in net income				492			492
Total other comprehensive loss							(1,464)
Total comprehensive income							9,881
Balance, June 30, 2006	\$ 42	\$	\$ 59,100	\$ (2,748)	\$ 18,057	\$	\$ 74,451
Balance, January 1, 2007	\$ 174	\$	\$ 153,600	\$ (761)	\$ 20,323	\$ (598)	\$ 172,738
Common stock issued, net of issuance costs	7		12,242				12,249
Cumulative effect adjustment upon adoption of SFAS 155				(133)	133		
Stock-based compensation			511				511

expense							
Comprehensive							
income:							
Net income				20,470			20,470
Other							
comprehensive							
income, net of tax							
Unrealized holding							
losses on securities							
arising during the							
period			(1,389)				(1,389)
Less reclassification							
adjustment for gains							
included in net							
income			(416)				(416)
Change in fair value							
of interest rate swap			230				230
Total other							
comprehensive							
income							(1,575)
Total comprehensive							
loss							18,895

Balance, June 30,
2007 \$ 181 \$ \$ 166,353 \$ (2,469) \$ 40,926 \$ (598) \$ 204,393

See accompanying notes to condensed consolidated financial statements.

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30,	
	2007	2006
	(Dollars in thousands)	
Cash Flows from Operating Activities		
Net Income	\$ 20,470	\$ 11,345
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	974	1,218
Realized (gains) losses on investments	(762)	482
Deferrals of acquisition costs, net	5,963	3,585
Deferred income taxes	(3,511)	(2,428)
Stock-based compensation expense	511	
Increase (decrease) in cash resulting from changes in assets and liabilities		
Premiums and reinsurance balances receivable	13,339	2,068
Accrued investment income	(900)	(274)
Receivable from related entity	(50)	1,814
Accrued profit sharing commissions	(1,803)	1,345
Reinsurance recoverable on paid and unpaid losses	(10,058)	(22,369)
Prepaid reinsurance premiums	(32,393)	(13,066)
Loss and loss adjustment expense reserves	44,849	37,077
Unearned premium reserves	24,899	10,892
Funds held under reinsurance treaties	19,268	
Reinsurance payable on paid losses	1,950	83
Premiums payable to insurance companies	1,054	(2,210)
Other	(2,089)	2,496
Net Cash Provided By Operating Activities	81,711	32,058
Cash Flows From Investing Activities		
Cost of short-term investments acquired	(224,301)	(99,507)
Proceeds from disposals of short-term investments	194,124	117,614
Cost of debt and equity securities acquired	(99,662)	(84,349)
Proceeds from debt and equity securities	30,733	51,769
Change in receivable from stockholders		222
Acquisition, net of cash acquired		(6,351)
Cost of fixed asset purchases	(2,118)	(55)
Net Cash Used In Investing Activities	(101,224)	(20,657)
Cash Flows From Financing Activities		
Issuance of common stock, net of issuance costs	12,249	243

Net Cash Provided By Financing Activities	12,249	243
Net (Decrease) Increase In Cash and Cash Equivalents	(7,264)	11,644
Cash and Cash Equivalents, beginning of period	14,335	8,400
Cash and Cash Equivalents, end of period	\$ 7,071	\$ 20,044

See accompanying notes to condensed consolidated financial statements.

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying condensed consolidated financial statements and notes of First Mercury Financial Corporation and Subsidiaries (FMFC or the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and do not contain all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. Readers are urged to review the Company s 2006 audited consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K for the year ended December 31, 2006 for a more complete description of the Company s business and accounting policies. In the opinion of management, all adjustments necessary for a fair presentation of the consolidated financial statements have been included. Such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results of operations for the full year. The consolidated balance sheet as of December 31, 2006 was derived from the Company s audited annual consolidated financial statements.

Significant intercompany transactions and balances have been eliminated.

In October 2006, the Company completed its initial public offering of common stock. Immediately preceding the initial public offering, First Mercury Holdings, Inc. (Holdings) was merged into FMFC with FMFC the surviving entity. The consolidated financial statements include the results of FMFC and its subsidiaries.

Use of Estimates

In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the consolidated financial statements, and revenues and expenses reported for the periods then ended. Actual results may differ from those estimates. Material estimates that are susceptible to significant change in the near term relate primarily to the determination of the reserves for losses and loss adjustment expenses.

Recently Issued Accounting Standards

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the potential impact that the adoption of SFAS 157 will have on its financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159), which provides reporting entities an option to report selected financial assets, including investment securities designated as available for sale, and liabilities, including most insurance contracts, at fair value. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The standard also requires additional information to aid financial statement users understanding of a reporting entity s choice to use fair value on its earnings and also requires entities to display on the face of the balance sheet the fair value of those assets and liabilities for which the reporting entity has chosen to measure at fair value. SFAS 159 is effective as of the beginning of a reporting entity s first fiscal year beginning after November 15, 2007. The Company has not elected the early adoption provisions of this standard. Because application of the standard is optional, any impacts are limited to those financial assets and liabilities to which SFAS 159 would be applied, which has yet to be determined.

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Concluded)***Stock Split***

On October 16, 2006, in connection with an initial public offering of the Company's common stock, the Company's Board of Directors and stockholders effected a 925-for-1 split of the Company's common stock. All share and per share amounts relating to common stock, included in the accompanying condensed consolidated financial statements and footnotes have been restated to reflect the stock split for all periods presented.

2. NET INCOME PER SHARE

Basic net income per share is computed by dividing net income by the weighted-average number of shares of common stock outstanding for the period. Diluted net income per share reflects the potential dilution that could occur if common stock equivalents were issued and exercised.

The following is a reconciliation of basic number of common shares outstanding to diluted common and common equivalent shares outstanding.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(Dollars in thousands, except share and per share data)			
Income	\$ 10,504	\$ 5,966	\$ 20,470	\$ 11,300
: Dividends in arrears		(921)		(1,500)
Income available to common	10,504	5,045	20,470	9,800
Weighted-average number of common and common equivalent shares outstanding:				
Basic number of common shares outstanding	17,428,006	4,216,144	17,380,219	4,216,144
Positive effect of stock options	823,432	820,232	831,270	820,232
Positive effect of unvested restricted stock	2,577		9,069	
Positive effect of convertible preferred stock		6,434,783		6,434,783
Positive effect of cumulative dividends on preferred stock		996,779		853,000
Diluted number of common and common equivalent shares outstanding	18,254,015	12,467,938	18,220,558	12,324,159
Basic Net Income Per Common Share	\$ 0.60	\$ 1.20	\$ 1.18	\$ 2.35
Diluted Net Income Per Common Share	\$ 0.58	\$ 0.48	\$ 1.12	\$ 0.80
Non-dilutive shares excluded from diluted net income per common share	95,292		49,273	

3. INCOME TAXES

On January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes, an Interpretation of SFAS No. 109* (FIN 48) which clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement

No. 109, *Accounting for Income Taxes*. FIN 48 requires an entity to recognize the benefit of tax positions only when it is more likely than not, based on the position's technical merits, that the position would be sustained upon examination by the respective taxing authorities. The tax benefit is measured as the largest benefit that is more than fifty-percent likely of being realized upon final settlement with the respective taxing authorities. The adoption of FIN 48 did not have an impact on our financial position or results of operations and we have taken no tax positions which would require disclosure under the new guidance. Although the IRS is not currently examining any of our income tax returns, tax years 2003, 2004, 2005 and 2006 remain open and are subject to examination.

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

3. INCOME TAXES (Concluded)

The Company files a consolidated federal income tax return with its subsidiaries. Taxes are allocated among the Company's subsidiaries based on the Tax Allocation Agreement employed by these entities, which provides that taxes of the entities are calculated on a separate-return basis at the highest marginal tax rate.

Income taxes in the accompanying unaudited condensed consolidated statements of income differ from the statutory tax rate of 35.0% primarily due to state income taxes, non-deductible expenses, and the nontaxable portion of dividends received and tax-exempt interest.

4. LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES

The Company establishes a reserve for both reported and unreported covered losses, which includes estimates of both future payments of losses and related loss adjustment expenses. The following represents changes in those aggregate reserves for the Company during the periods presented below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(Dollars in thousands)			
Balance , beginning of period	\$ 211,271	\$ 132,949	\$ 191,013	\$ 113,864
Less reinsurance recoverables	69,126	31,736	66,926	21,869
Net Balance , beginning of period	142,145	101,213	124,087	91,995
Incurred Related To				
Current year	23,225	14,503	47,294	28,904
Prior years	(737)	552	(852)	1,058
Total Incurred	22,488	15,055	46,442	29,962
Paid Related To				
Current year	977	687	1,154	791
Prior years	5,179	6,991	10,898	12,576
Total Paid	6,156	7,678	12,052	13,367
Net Balance	158,477	108,590	158,477	108,590
Plus reinsurance recoverables	77,385	42,350	77,385	42,350
Balance , end of period	\$ 235,862	\$ 150,940	\$ 235,862	\$ 150,940

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

5. REINSURANCE

Net written and earned premiums, including reinsurance activity, were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(Dollars in thousands)			
Written Premiums				
Direct	\$ 74,217	\$ 55,443	\$ 133,551	\$ 110,980
Assumed	3,101	923	4,367	2,262
Ceded	(33,241)	(29,537)	(59,381)	(59,305)
Net Written Premiums	\$ 44,077	\$ 26,829	\$ 78,537	\$ 53,937
Earned Premiums				
Direct	\$ 56,818	\$ 51,511	\$ 110,192	\$ 100,372
Assumed	2,751	850	3,837	1,615
Ceded	(17,410)	(24,598)	(28,474)	(45,876)
Earned but unbilled premiums	1,412	565	2,945	746
Net Earned Premiums	\$ 43,571	\$ 28,328	\$ 88,500	\$ 56,857

The Company manages its credit risk on reinsurance recoverables by reviewing the financial stability, A.M. Best rating, capitalization, and credit worthiness of prospective and existing risk-sharing partners. The Company customarily collateralizes reinsurance balances due from unauthorized reinsurers through funds withheld, grantor trusts, or stand-by letters of credit issued by highly rated banks.

The Company's 2007 ceded reinsurance program includes quota share reinsurance agreements with authorized reinsurers that were entered into and are accounted for on a funds withheld basis. Under the funds withheld basis, the Company records the ceded premiums payable to the reinsurer, less ceded paid losses and loss adjustment expenses receivable from the reinsurer, less any amounts due to the reinsurer for the reinsurer's margin, or cost of the reinsurance contract, as a liability, and reported \$19.3 million as Funds held under reinsurance treaties in the accompanying Condensed Interim Consolidated Balance Sheets at June 30, 2007. As specified under the terms of the agreements, the Company credits the funds withheld balance at stated interest crediting rates applied to the funds withheld balance. If the funds withheld liability is exhausted, interest crediting would cease and additional claim payments would be recoverable from the reinsurer.

Interest cost on reinsurance contracts accounted for on a funds withheld basis is incurred during all periods in which a funds withheld liability exists or as otherwise specified under the terms of the contract and is included in Underwriting, agency and other expenses. The amount subject to interest crediting rates was \$9.8 million at June 30, 2007. There were no amounts subject to such interest crediting at June 30, 2006 or December 31, 2006.

6. RELATED PARTY TRANSACTIONS

First Home Insurance Agency (FHIA) is considered a related party to the Company due to common ownership of FHIA and the Company. The Company provides systems support, accounting, human resources, claims and regulatory oversight for FHIA under an administrative services and cost allocation agreement. Under the terms of this agreement, FMFC allocates actual expenses and costs related to the activities discussed above. Costs related to this agreement were \$0.2 million and \$0.3 million for the three and six months ended June 30, 2007, respectively and \$0.2 million

and \$0.4 million for the three and six months ended June 30, 2006, respectively. As of June 30, 2007 and 2006, the Company had a receivable for these charges and other advances of \$0.1 million and \$0.1 million, respectively, from FHIA.

In the second quarter of 2006, prior to its initial public offering, the Company forgave its \$0.8 million unsecured loan due from its chief executive officer and recorded the amount as compensation.

The Company entered into a consulting agreement during the fourth quarter of 2006 with its founder, who currently serves as a director. The agreement has a three year term and provides for an annual consulting fee of \$1.0 million. The Company recorded consulting expense of \$0.3 million and \$0.5 million for the three and six months ended June 30, 2007, respectively, related to this agreement.

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

7. HYBRID INSTRUMENTS

On January 1, 2007, the Company elected to adopt the fair value provisions of SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* (SFAS 155) for all of its convertible securities which were previously accounted for as embedded derivatives in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). The Company adopted SFAS 155 in order to simplify the accounting for these convertible securities. On January 1, 2007, unrealized gains on these convertible securities were \$0.5 million and unrealized losses were \$0.3 million. The adoption of SFAS 155 resulted in a cumulative effect adjustment of \$0.1 million, net of tax, to reclassify the unrealized holding gain on the host portion of the convertible securities into retained earnings.

As of June 30, 2007, the market value of convertible securities accounted for as hybrid instruments was \$29.7 million. Convertible bonds and bond units had a market value of \$27.0 million and were included in Debt securities in the Condensed Interim Consolidated Balance Sheet at June 30, 2007. Convertible preferred stocks had a market value of \$2.7 million and were included in Equity securities and other in the Condensed Interim Consolidated Balance Sheet at June 30, 2007. The Company recorded an increase in the fair value of the hybrid instruments of \$0.3 million and \$0.1 million in Net realized gains (losses) on investments for the three and six months ended June 30, 2007, respectively. As of June 30, 2007, there were no convertible securities that were not accounted for as hybrid instruments in accordance with SFAS 155.

8. STOCK COMPENSATION PLANS

The 1998 Stock Compensation Plan (the 1998 Plan) was established September 3, 1998. Under the terms of the plan, directors, officers, employees and key individuals may be granted options to purchase the Company's common stock. A total of 4,625,000 shares of the Company's common stock are reserved for future grant under the plan. Option and vesting periods and option exercise prices are determined by the Compensation Committee of the Board of Directors, provided no stock options shall be exercisable more than ten years after the grant date. All outstanding stock options under the plan became fully vested on August 17, 2005 under the change in control provision in the plan. During the first quarter of 2006, the Company granted 76,312 stock options to a certain officer under the 1998 Plan. These options became fully vested on the date of the Company's initial public offering. Shares available for future grant under the 1998 Plan totaled 2,443,388 at June 30, 2007, however, the Company does not intend to issue any additional awards under this plan.

The First Mercury Financial Corporation Omnibus Incentive Plan of 2006 (the Omnibus Plan) was established October 16, 2006. The Company has reserved 1,500,000 shares of its common stock for future granting of stock options, stock appreciation rights (SAR), restricted stock, restricted stock units (RSU), deferred stock units (DSU), performance shares, performance cash awards, and other stock or cash awards to employees and non-employee directors at any time prior to October 15, 2016. All of the terms of the vesting or other restrictions will be determined by the Compensation Committee of the Company's Board of Directors. The exercise price will not be less than the fair market value of the shares on the date of grant. During the three and six months ended June 30, 2007, the Company granted 10,000 and 226,188 stock options, respectively, to employees and 5,960 and 10,148 shares of restricted stock, respectively, to non-employee directors under the Omnibus Plan. The stock options vest in three equal installments over a period of three years on the anniversary of the grant date. The shares of restricted stock vest immediately, but will not be transferable for one year after the grant date. Stock-based compensation will be recognized over the expected vesting period of the stock options and is recognized immediately for the restricted stock. Shares available for future grants under the Omnibus Plan totaled 1,013,664 at June 30, 2007.

During the fourth quarter of 2006, the Company awarded 48,100 shares of restricted stock to a certain officer. Half of the restricted stock vested on the date of grant and the remainder vested during the second quarter of 2007. Stock-based compensation was recognized over the vesting period of the restricted stock.

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

8. STOCK COMPENSATION PLANS (Continued)

The following table summarizes stock option activity for the six months ended June 30, 2007 and 2006.

	1998 Plan		Omnibus Plan	
	Number of	Weighted	Number	Weighted
	Options	Average	of	Average
		Exercise		Exercise
		Price		Price
Outstanding at January 1, 2006	1,119,528	\$ 1.85		\$
Granted during the period	76,312	6.49		
Forfeited during the period				
Exercised during the period				
Cancelled during the period				
Outstanding at June 30, 2006	1,195,840	\$ 2.12		\$
Outstanding at January 1, 2007	927,775	\$ 2.24	250,000	\$ 17.00
Granted during the period			226,188	20.74
Forfeited during the period				
Exercised during the period				
Cancelled during the period				
Outstanding at June 30, 2007	927,775	\$ 2.24	476,188	\$ 18.78
Exercisable at:				
June 30, 2006	1,119,528	\$ 1.85		
June 30, 2007	927,775	\$ 2.24		

The aggregate intrinsic value of fully vested options outstanding and exercisable under the 1998 Plan was \$17.4 million at June 30, 2007. The aggregate intrinsic value of options expected to vest under the Omnibus Plan was \$1.0 million at June 30, 2007.

The number of stock option awards outstanding and exercisable at June 30, 2007 by range of exercise prices was as follows:

	Options Outstanding			Options Exercisable	
	Weighted-Average	Weighted-Average		Weighted-Average	
Range of	Outstanding	Exercise		Exercise	
	as of June	Price Per		as of	Price Per
	30, 2007	Share		June 30,	Share
Exercisable Price				2007	
1998 Plan					
\$1.51 - \$2.14	810,762	3.73 Years	\$ 1.71	810,762	\$ 1.71
\$4.86 - \$6.49	117,013	6.52	5.92	117,013	5.92
Total	927,775	4.08	2.24	927,775	2.24

Omnibus Plan

\$17.00 - \$20.55	476,188	7.91 Years	\$ 18.78	\$
-------------------	---------	------------	----------	----

Total	476,188	7.91	\$ 18.78	\$
--------------	---------	------	----------	----

As of June 30, 2007, there was approximately \$2.6 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Omnibus Plan and non-vested restricted stock. That cost is expected to be recognized over a weighted-average period of 2.4 years.

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

8. STOCK COMPENSATION PLANS (Concluded)

The fair value of stock options granted during the six months ended June 30, 2007 and 2006 were determined on the dates of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Six Months Ended June 30,	
	2007	2006
1998 Plan		
Expected term		2.5
Expected stock price volatility		26.51%
Risk-free interest rate		4.72%
Expected dividend yield		
Estimated fair value per option		\$ 1.39
Omnibus Plan		
Expected term	5.0	
Expected stock price volatility	26.50%	
Risk-free interest rate	4.50%	
Expected dividend yield		
Estimated fair value per option	\$ 6.71	

For 2007, the expected term of options was determined based on the simplified method from SEC Staff Accounting Bulletin No. 107, *Share-Based Payment* (*SAB 107*). Expected stock price volatility was based on an average of the volatility factors utilized by companies within the Company's peer group. Prior to the adoption of SFAS No. 123(R), *Share-Based Payment* (*SFAS 123(R)*), expected term was based on the contractual term of the award and price volatility was not utilized in the Company's calculation. The risk-free interest rate is based on the yield of U.S. Treasury securities with an equivalent remaining term. The Company has not paid dividends in the past and does not plan to pay any dividends in the near future.

The assumptions used to calculate the fair value of options granted are evaluated and revised, as necessary, to reflect market conditions and the Company's historical experience and future expectations. The calculated fair value is recognized as compensation cost in the Company's financial statements over the requisite service period of the entire award. Compensation cost is recognized only for those options expected to vest, with forfeitures estimated at the date of grant and evaluated and adjusted periodically to reflect the Company's historical experience and future expectations. Any change in the forfeiture assumption is accounted for as a change in estimate, with the cumulative effect of the change on periods previously reported being reflected in the financial statements of the period in which the change is made.

The Company accounts for the compensation costs related to its grants under the stock compensation plans in accordance with SFAS 123(R). The Company recognized stock-based compensation expense of \$0.5 million for the three and six months ended June 30, 2007, respectively.

9. STOCKHOLDERS' EQUITY

On May 25, 2007, the Company filed a registration statement on Form S-1 with the Securities and Exchange Commission for the purpose of making a follow-on offering of common stock. The Company's registration statement was declared effective on June 14, 2007. Upon completion of the follow-on offering on June 27, 2007, gross proceeds from the sale of 695,189 shares of common stock, including 495,189 shares of common stock sold to the underwriters of the offering pursuant to the underwriters' exercise of their over-allotment option, at an offering price per share of \$19.25, totaled \$13.4 million. Costs associated with the follow-on offering included \$0.8 million of underwriting costs and \$0.4 million of other issuance costs.

10. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The Company's accumulated other comprehensive income (loss) included the following:

13

Table of Contents

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

	June 30,	
	2007	2006
	(Dollars in thousands)	
Unrealized holding losses on securities, net of tax	(2,691)	(2,748)
Fair value of interest rate swap, net of tax	222	
Total accumulated other comprehensive loss	\$ (2,469)	\$ (2,748)

Table of Contents

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q contains forward-looking statements that relate to future periods and includes statements regarding our anticipated performance. Generally, the words anticipates, believes, expects, intends, estimates, projects, plans and similar expressions identify forward-looking statements. These forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause our actual results, performance or achievements or industry results to differ materially from any future results, performance or achievements expressed or implied by these forward-looking statements. These risks, uncertainties and other important factors include, among others: our ability to maintain or the lowering or loss of one of our financial or claims-paying ratings; our actual incurred losses exceeding our loss and loss adjustment expense reserves; the failure of reinsurers to meet their obligations; our inability to obtain reinsurance coverage at reasonable prices; the failure of any loss limitations or exclusions or changes in claims or coverage; our lack of long-term operating history in certain specialty classes of insurance; our ability to acquire and retain additional underwriting expertise and capacity; the concentration of our insurance business in relatively few specialty classes; competition risk; fluctuations and uncertainty within the excess and surplus lines insurance industry; the extensive regulations to which our business is subject and our failure to comply with those regulations; our ability to maintain our risk-based capital at levels required by regulatory authorities; our inability to realize our investment objectives; and the risks identified in our filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K. Given these uncertainties, you are cautioned not to place undue reliance on these forward-looking statements. We assume no obligation to update or revise them or provide reasons why actual results may differ.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the related notes included elsewhere in this Form 10-Q.

Overview

We are a provider of insurance products and services to the specialty commercial insurance markets, primarily focusing on niche and underserved segments where we believe that we have underwriting expertise and other competitive advantages. During our 34 years of underwriting security risks, we have established CoverX[®] as a recognized brand among insurance agents and brokers and developed underwriting expertise and a cost-efficient infrastructure. Over the last seven years, we have leveraged our brand, expertise and infrastructure to expand into other specialty classes of business, particularly focusing on smaller accounts that receive less attention from competitors.

First Mercury Financial Corporation (FMFC) is a holding company for our operating subsidiaries. Our operations are conducted with the goal of producing overall profits by strategically balancing underwriting profits from our insurance subsidiaries with the commissions and fee income generated by our non-insurance subsidiaries. FMFC's principal operating subsidiaries are CoverX Corporation (CoverX), First Mercury Insurance Company (FMIC), All Nation Insurance Company (ANIC) and American Risk Pooling Consultants, Inc. (ARPCO).

CoverX produces and underwrites all of the insurance policies for which we retain risk and receive premiums. As a wholesale insurance broker, CoverX markets our insurance policies through a nationwide network of wholesale and retail insurance brokers who then distribute these policies through retail insurance brokers. CoverX also provides underwriting services with respect to the insurance policies it markets in that it reviews the applications submitted for insurance coverage, decides whether to accept all or part of the coverage requested and determines applicable premiums. CoverX receives commissions from affiliated insurance companies, reinsurers, and non-affiliated insurers as well as policy fees from wholesale and retail insurance brokers.

FMIC and ANIC are our two insurance subsidiaries. FMIC writes substantially all the policies produced by CoverX. ANIC provides quota share reinsurance to FMIC. FMIC also provides claims handling and adjustment services for policies produced by CoverX and directly written by third parties.

ARPCO provides third party administrative services for risk sharing pools of governmental entity risks, including underwriting, claims, loss control and reinsurance services. ARPCO is solely a fee-based business and receives fees for these services and commissions on excess per occurrence insurance placed in the commercial market with third party companies on behalf of the pools.

Table of Contents

Premiums Produced

We use the operational measure premiums produced to identify premiums generated from insurance policies sold through CoverX on insurance policies that it produces and underwrites on behalf of FMIC and under fronting relationships. Premiums produced includes both our direct written premiums and premiums directly written by our fronting insurers, all of which are produced and underwritten by CoverX. Although the premiums underwritten by CoverX under fronting relationships are directly written by the fronting insurer, we control the ultimate placement of those premiums, by either assuming the premiums by our insurance subsidiaries or arranging for the premiums to be ceded to third party reinsurers. The operational measure premiums produced is used by our management, reinsurers, creditors and rating agencies as a meaningful measure of the dollar growth of our underwriting operations because it represents the premiums that we control by directly writing insurance and by our fronting relationships. It is also a key indicator of our insurance underwriting operations revenues, and is the basis for broker commission expense calculations in our consolidated income statement. We generate direct and net earned premium income from premiums directly written by our insurance subsidiaries, and generate commission income, profit sharing commission income and assumed written and earned premiums from premiums directly written by third party insurance companies. We believe that premiums produced is an important operational measure of our insurance underwriting operations, and refer to it in the following discussion and analysis of financial condition and results of our operations.

Critical Accounting Policies

The critical accounting policies discussed below are important to the portrayal of our financial condition and results of operations and require us to exercise significant judgment. We use significant judgments concerning future results and developments in making these critical accounting estimates and in preparing our consolidated financial statements. These judgments and estimates affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of material contingent assets and liabilities. We evaluate our estimates on a continual basis using information that we believe to be relevant. Actual results may differ materially from the estimates and assumptions used in preparing the consolidated financial statements.

Readers are also urged to review Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Note 1 to the audited consolidated financial statements thereto included in the Annual Report on Form 10-K for the year ended December 31, 2006 on file with the Securities and Exchange Commission for a more complete description of our critical accounting policies and estimates.

Use of Estimates

In preparing our consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the consolidated financial statements, and revenues and expenses reported for the periods then ended. Actual results may differ from those estimates. Material estimates that are susceptible to significant change in the near term relate primarily to the determination of the reserves for losses and loss adjustment expenses.

Loss and Loss Adjustment Expense Reserves

The reserves for losses and loss adjustment expenses represent our estimated ultimate costs of all reported and unreported losses and loss adjustment expenses incurred and unpaid at the balance sheet date. Our reserves reflect our estimates at a given time of amounts that we expect to pay for losses that have been reported, which are referred to as Case reserves, and losses that have been incurred but not reported and the expected development of losses and allocated loss adjustment expenses on open reported cases, which are referred to as IBNR reserves. We do not discount the reserves for losses and loss adjustment expenses.

We allocate the applicable portion of our estimated loss and loss adjustment expense reserves to amounts recoverable from reinsurers under ceded reinsurance contracts and report those amounts separately from our loss and loss adjustment expense reserves as an asset on our balance sheet.

Table of Contents

The estimation of ultimate liability for losses and loss adjustment expenses is an inherently uncertain process. Our loss and loss adjustment expense reserves do not represent an exact measurement of liability, but are our estimates based upon various factors, including:

actuarial projections of what we, at a given time, expect to be the cost of the ultimate settlement and administration of claims reflecting facts and circumstances then known;

estimates of future trends in claims severity and frequency;

assessment of asserted theories of liability; and

analysis of other factors, such as variables in claims handling procedures, economic factors, and judicial and legislative trends and actions.

Most or all of these factors are not directly or precisely quantifiable, particularly on a prospective basis, and are subject to a significant degree of variability over time. In addition, the establishment of loss and loss adjustment expense reserves makes no provision for the broadening of coverage by legislative action or judicial interpretation or for the extraordinary future emergence of new types of losses not sufficiently represented in our historical experience or which cannot yet be quantified. Accordingly, the ultimate liability may be more or less than the current estimate. The effects of changes in the estimated reserves are included in the results of operations in the period in which the estimate is revised.

Our reserves consist entirely of reserves for liability losses, consistent with the coverages provided for in the insurance policies directly written or assumed by the Company under reinsurance contracts. In many cases, several years may elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of the loss. The estimation of ultimate liability for losses and loss adjustment expenses is an inherently uncertain process, requiring the use of informed estimates and judgments. Our loss and loss adjustment expense reserves do not represent an exact measurement of liability, but are estimates. Although we believe that our reserve estimates are reasonable, it is possible that our actual loss experience may not conform to our assumptions and may, in fact, vary significantly from our assumptions. Accordingly, the ultimate settlement of losses and the related loss adjustment expenses may vary significantly from the estimates included in our financial statements. We continually review our estimates and adjust them as we believe appropriate as our experience develops or new information becomes known to us. Such adjustments are included in current operations.

Our reserves for losses and loss adjustment expenses at June 30, 2007 and December 31, 2006, gross and net of ceded reinsurance were as follows:

	June 30, 2007	December 31, 2006
	(Dollars in thousands)	
Gross		
Case reserves	\$ 54,509	\$ 47,004
IBNR and ULAE reserves	181,353	144,009
Total reserves	\$ 235,862	\$ 191,013
Net of reinsurance		
Case reserves	\$ 42,657	\$ 37,376
IBNR and ULAE reserves	115,820	86,711
Total	\$ 158,477	\$ 124,087

Revenue Recognition

Premiums. Premiums are recognized as earned using the daily pro rata method over the terms of the policies. When premium rates increase, the effect of those increases will not immediately affect earned premium. Rather, those increases will be recognized ratably over the period of coverage. Unearned premiums represent the portion of premiums written that relate to the unexpired terms of policies-in-force. As policies expire, we audit those policies comparing the estimated premium rating units that were used to set the

Table of Contents

initial premium to the actual premiums rating units for the period and adjust the premiums accordingly. Premium adjustments identified as a result of these audits are recognized as earned when identified.

Commissions and Fees. Wholesale agency commissions and fee income from unaffiliated companies are earned at the effective date of the related insurance policies produced or as services are provided under the terms of the administrative and service provider contracts. Related commissions to retail agencies are concurrently expensed at the effective date of the related insurance policies produced. Profit sharing commissions due from certain insurance companies, based on losses and loss adjustment expense experience, are earned when determined and communicated by the applicable insurance company.

Investments

Our marketable investment securities, including money market accounts held in our investment portfolio, are classified as available-for-sale and, as a result, are reported at market value. A decline in the market value of any security below cost that is deemed other than temporary is charged to earnings and results in the establishment of a new cost basis for the security. In most cases, declines in market value that are deemed temporary are excluded from earnings and reported as a separate component of stockholders' equity, net of the related taxes, until realized. The exception of this rule relates to investments in convertible securities with embedded derivatives. These convertible securities were accounted for under SFAS No. 155 *Accounting for Certain Hybrid Financial Instruments* (*SFAS 155*) for the three and six months ended June 30, 2007 and under SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities* (*SFAS 133*) for the three and six months ended June 30, 2006.

Premiums and discounts are amortized or accreted over the life of the related debt security as an adjustment to yield using the effective-interest method. Dividend and interest income are recognized when earned. Realized gains and losses are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

Deferred Policy Acquisition Costs

Policy acquisition costs related to direct and assumed premiums consist of commissions, underwriting, policy issuance, and other costs that vary with and are primarily related to the production of new and renewal business, and are deferred, subject to ultimate recoverability, and expensed over the period in which the related premiums are earned. Investment income is included in the calculation of ultimate recoverability.

Intangible Assets

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* , intangible assets that are not subject to amortization shall be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test shall consist of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss shall be recognized in an amount equal to that excess.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*, the carrying value of long-lived assets, including amortizable intangibles and property and equipment, are evaluated whenever events or changes in circumstances indicate that a potential impairment has occurred relative to a given asset or assets. Impairment is deemed to have occurred if projected undiscounted cash flows associated with an asset are less than the carrying value of the asset. The estimated cash flows include management's assumptions of cash inflows and outflows directly resulting from the use of that asset in operations. The amount of the impairment loss recognized is equal to the excess of the carrying value of the asset over its then estimated fair value.

Table of Contents***Results of Operations******Three Months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006***

The following table summarizes our results for the three months ended June 30, 2007 and 2006:

	Three Months Ended June 30,		
	2007	2006	Change
	(Dollars in thousands)		
Operating Revenue			
Net earned premiums	\$ 43,571	\$ 28,328	54%
Commissions and fees	4,902	4,319	13
Net investment income	3,870	2,121	82
Net realized gains (losses) on investments	627	(329)	291
Total Operating Revenues	52,970	34,439	54
Operating Expenses			
Losses and loss adjustment expenses, net	22,488	15,055	49
Amortization of intangible assets	307	291	5
Other operating expenses	13,170	7,367	79
Total Operating Expenses	35,965	22,713	58
Operating Income	17,005	11,726	45
Interest Expense	859	2,590	(67)
Income Before Income Taxes	16,146	9,136	77
Income Taxes	5,642	3,170	78
Net Income	\$ 10,504	\$ 5,966	76%
Loss Ratio	51.6%	53.1%	(1.5 points)
Underwriting Expense Ratio	22.4%	15.6%	6.8 points
Combined Ratio	74.0%	68.7%	5.3 points

Premiums Produced

Premiums produced, which consists of all of the premiums underwritten by CoverX, for the three months ended June 30, 2007 were \$78.3 million, a \$19.1 million, or 32%, increase over \$59.2 million in premiums produced during the three months ended June 30, 2006. During the second quarter 2007, we added three new niche specialty liability classes and one new underwriter of an existing class, which generated approximately \$8.5 million in premiums produced. In addition, net new business from the opening of the Company's California underwriting office during the fourth quarter of 2006 and continuing growth from our existing underwriting offices generated an additional \$9.6 million in premiums produced. Increased audit premium and continued growth in other specialty class programs accounted for the remainder of the increase.

Table of Contents***Operating Revenue
Net Earned Premiums***

	Three Months Ended June 30,		
	2007	2006	Change
	(Dollars in thousands)		
Written premiums			
Direct	\$ 74,217	\$ 55,443	34%
Assumed	3,101	923	236
Ceded	(33,241)	(29,537)	13
Net written premiums	\$ 44,077	\$ 26,829	64%
Earned premiums			
Direct	\$ 56,818	\$ 51,511	10%
Assumed	2,751	850	224
Ceded	(17,410)	(24,598)	(29)
Earned but unbilled premiums	1,412	565	150
Net earned premiums	\$ 43,571	\$ 28,328	54%

Direct written premiums increased \$18.8 million, or 34%, primarily due to the addition of three new niche specialty liability classes and one new underwriter of an existing class in the second quarter 2007, the opening of the Company's California underwriting office in December 2006 and the growth in premiums produced by existing underwriting offices during the three months ended June 30, 2007. Direct earned premiums increased \$5.3 million, or 10%, in the three months ended June 30, 2007 compared to the three months ended June 30, 2006.

Assumed written premiums increased \$2.2 million, or 236%, and assumed earned premiums increased \$1.9 million, or 224%. The increase in assumed written premiums is due to the growth in the admitted legal liability sub-class written through a fronting insurer, and an increase in the assumed quota share from 30% to 100% on this fronted sub-class.

Ceded written premiums increased \$3.7 million, or 13%, and ceded earned premiums decreased \$7.2 million, or 29%, in the three months ended June 30, 2007 compared to the three months ended June 30, 2006. Ceded written premiums increased principally due to the increase in direct written premiums and the 50% quota share reinsurance on a portion of the new niche specialty class premiums, offset somewhat by purchasing less reinsurance during the second quarter of 2007 compared the second quarter of 2006. Ceded earned premiums decreased primarily due to the termination of the Company's 2006 50% quota share reinsurance treaties on December 31, 2006 on a cut-off basis, resulting in the previously ceded unearned premiums being returned to the Company on that date, so that there were no ceded earned premiums related to the 50% reinsurance treaties during the three months ended June 30, 2007. The three months ended June 30, 2006 included ceded earned premiums related to the 2005 quota share reinsurance treaties which continued into 2006. The effect of the December 31, 2006 50% quota share cut-off reinsurance termination was to reduce ceded earned premiums for the three months ended June 30, 2007 by approximately \$12.3 million, and to increase net earned premiums by the same amount.

Earned but unbilled premiums increased \$0.8 million, or 150%, primarily due to the growth in the rate of audit premiums to original premiums written during 2006, recognition of increased audit premium collection experience, and growth in net retained earned premiums subject to premium audits.

Table of Contents***Commissions and Fees***

	Three Months Ended June 30,		
	2007	2006	Change
	(Dollars in thousands)		
Insurance underwriting commissions and fees	\$ 2,063	\$ 1,613	28%
Insurance services commissions and fees	2,839	2,706	5
Total commissions and fees	\$ 4,902	\$ 4,319	13%

Insurance underwriting commissions and fees increased \$0.5 million, or 28%, from the three months ended June 30, 2006 to the three months ended June 30, 2007, principally due to increases in commissions on fronted premiums. Insurance services commissions and fees, which were principally ARPCO income and not related to premiums produced, increased \$0.1 million, or 5%, principally as the result of increased claims handling fees.

Net Investment Income and Realized Gains on Investments. During the three months ended June 30, 2007, net investment income earned was \$3.9 million, a \$1.8 million, or 82%, increase from \$2.1 million reported in the three months ended June 30, 2006 primarily due to the increase in invested assets over the period. At June 30, 2007, invested assets were \$395.9 million, a \$172.7 million, or 77%, increase over \$223.2 million of invested assets at June 30, 2006 due to increases in net written premiums, proceeds from our initial public and secondary offerings, proceeds from the issuance of trust preferred securities, cash received for the unearned premiums related to the 2006 50% quota share reinsurance contract terminated on a cut-off basis, and from the cash retained on our 35% quota share reinsurance contracts on a funds withheld basis. Net investment income earned continued to benefit from higher reinvestment rates as proceeds from maturing bonds were reinvested at currently higher interest rates. The annualized investment yield (net of investment expenses) was 4.0% and 3.7% at June 30, 2007 and June 30, 2006, respectively. The increase was the result of the general increase in market interest rates offset by increased allocation to municipal securities. The annualized tax equivalent yield on total investments was 4.8% and 4.4% at June 30, 2007 and 2006, respectively.

During the three months ended June 30, 2007, net realized gains on investments were \$0.6 million, a \$0.9 million increase over the net realized capital loss of \$0.3 million during the three months ended June 30, 2006. The net realized gains were principally due to sales of investment securities at gains of approximately \$0.3 million and mark to market increases of \$0.3 million in convertible bonds carried at market in accordance with SFAS 155.

Operating Expenses

Losses and Loss Adjustment Expenses. Losses and loss adjustment expenses incurred increased \$7.4 million, or 49%, in the three months ended June 30, 2007 compared to the three months ended June 30, 2006. Growth from the increase in net earned exposure growth reflected in the 54% net earned premiums growth and an increase in the accident year loss and loss adjustment expense ratio was offset by approximately \$0.7 million in favorable development of December 31, 2006 and prior years' loss adjustment expense reserves in the three months ended June 30, 2007, as compared to the \$0.5 million in unfavorable loss and loss adjustment expense reserves development report of December 31, 2005 and prior reserves reported during the second quarter of 2006.

Other Operating Expenses

	Three Months Ended June 30,		
	2007	2006	Change
	(Dollars in thousands)		
Amortization of deferred acquisition expenses	\$ 7,557	\$ 4,198	80%
Ceded reinsurance commissions	(9,840)	(8,899)	11
Other underwriting and operating expenses	15,453	12,068	28

Other operating expenses	\$ 13,170	\$ 7,367	79%
--------------------------	-----------	----------	-----

During the three months ended June 30, 2007, other operating expenses increased \$5.8 million, or 79%, from the three months ended June 30, 2006. Amortization of deferred acquisition expenses increased by \$3.4 million, or 80%, including a \$4.0 million

21

Table of Contents

increase related to the approximately \$12.3 million in net premiums earned due to the termination on a cut-off basis of the 2006 50% quota share reinsurance treaties on December 31, 2006 offset by a decrease of \$0.6 million related to remaining net earned premiums during the three months ended June 30, 2007. Ceded reinsurance commissions increased \$0.9 million, or 11%, principally due to the growth in ceded written premiums and an increase in ceding commission rates, offset by the effect of purchasing 35% quota share reinsurance during the second quarter of 2007 compared to purchasing 50% quota share reinsurance during the second quarter of 2006. Other underwriting and operating expenses, which consist of commissions, other acquisition costs, and general and underwriting expenses, net of acquisition cost deferrals, increased by \$3.4 million, or 28%, principally due to increased commissions and other acquisition costs, net of acquisition cost deferrals of \$2.6 million, and an increase of \$0.8 million in general and underwriting expenses.

Interest Expense

	Three Months Ended		
	June 30,		
	2007	2006	Change
	(Dollars in thousands)		
Senior notes	\$	\$ 1,959	(100)%
Junior subordinated debentures	859	304	183
Other		327	(100)
Total interest expense	\$ 859	\$ 2,590	(67)%

Interest expense decreased \$1.7 million, or 67%, from the three months ended June 30, 2006 to the three months ended June 30, 2007. This decrease was principally attributable to a \$2.0 million decrease in interest expense related to the \$65.0 million senior notes issued in August 2005 and repaid in October 2006. This decrease was offset by a \$0.6 million increase in interest expense related to junior subordinated debentures of \$46.4 million and \$20.6 million at June 30, 2007 and 2006, respectively, which included the change in fair value of interest rate swap on junior subordinated debentures as discussed in Liquidity and Capital Resources.

Income taxes. Our effective tax rates were approximately 34.9% and 34.7% for the three months ended June 30, 2007 and June 30, 2006, respectively.

Table of Contents***Six Months Ended June 30, 2007 Compared to Six Months Ended June 30, 2006***

The following table summarizes our results for the six months ended June 30, 2007 and 2006:

	Six Months Ended June 30,		
	2007	2006	Change
	(Dollars in thousands)		
Operating Revenue			
Net earned premiums	\$ 88,500	\$ 56,857	56%
Commissions and fees	9,559	8,763	9
Net investment income	7,164	4,271	68
Net realized gains (losses) on investments	762	(482)	258
Total Operating Revenues	105,985	69,409	53
Operating Expenses			
Losses and loss adjustment expenses, net	46,442	29,962	55
Amortization of intangible assets	613	583	5
Other operating expenses	25,640	16,471	56
Total Operating Expenses	72,695	47,016	55
Operating Income	33,290	22,393	49
Interest Expense	1,949	5,009	(61)
Income Before Income Taxes	31,341	17,384	80
Income Taxes	10,871	6,039	80
Net Income	\$ 20,470	\$ 11,345	80%
Loss Ratio	52.5%	52.7%	(0.2 points)
Underwriting Expense Ratio	21.4%	19.1%	2.3 points
Combined Ratio	73.9%	71.8%	2.1 points

Premiums Produced

Premiums produced, which consists of all of the premiums underwritten by CoverX, for the six months ended June 30, 2007 were \$142.5 million, a \$23.4 million, or 19.7%, increase over \$119.1 million in premiums produced during the six months ended June 30, 2006. During the second quarter 2007, we added three new niche specialty liability classes and one new underwriter of an existing class which generated approximately \$8.5 million in premiums produced. In addition, net new business from the opening of the Company's California underwriting office during the fourth quarter of 2006 and continuing growth from our existing underwriting offices generated an additional \$13.2 million in premiums produced. Increased audit premium and continued growth in other specialty class programs accounted for the remainder of the increase.

Table of Contents***Operating Revenue
Net Earned Premiums***

	Six Months Ended June 30,		
	2007	2006	Change
	(Dollars in thousands)		
Written premiums			
Direct	\$ 133,551	\$ 110,980	20%
Assumed	4,367	2,262	93
Ceded	(59,381)	(59,305)	0
Net written premiums	\$ 78,537	\$ 53,937	46%
Earned premiums			
Direct	\$ 110,192	\$ 100,372	10%
Assumed	3,837	1,615	138
Ceded	(28,474)	(45,876)	(38)
Earned but unbilled premiums	2,945	746	295
Net earned premiums	\$ 88,500	\$ 56,857	56%

Direct written premiums increased \$22.6 million, or 20%, primarily due to the addition of three new niche specialty liability classes and one new underwriter of an existing class in the second quarter 2007, the opening of the Company's California underwriting office in December 2006 and the growth in premiums produced by existing underwriting offices during the six months ended June 30, 2007. Direct earned premiums increased \$9.8 million, or 10%, in the six months ended June 30, 2007 compared to the six months ended June 30, 2006.

Assumed written premiums increased \$2.1 million, or 93%, and assumed earned premiums increased \$2.2 million, or 138%. The increased in assumed written premiums is due to the growth in the admitted legal liability sub-class written through a fronting insurer and an increase in the assumed quota share reinsurance contract on this fronted sub-class.

Ceded written premiums were flat due to the increase in net written premiums offset by lower quota share reinsurance for the six months ended June 30, 2007 compared to the six months ended June 30, 2006, and ceded earned premiums decreased \$17.4 million, or 38%, in the six months ended June 30, 2007 compared to the six months ended June 30, 2006. Ceded earned premiums decreased primarily due to the termination of the Company's 2006 50% quota share reinsurance treaties on December 31, 2006 on a cut-off basis, resulting in the previously ceded unearned premiums being returned to the Company on that date, so that there were no ceded earned premiums related to the 50% reinsurance treaties during the six months ended June 30, 2007. The six months ended June 30, 2006 included ceded earned premiums related to the 2005 quota share reinsurance treaties which continued into 2006. The effect of the December 31, 2006 50% quota share cut-off reinsurance termination was to reduce ceded earned premiums for the six months ended June 30, 2007 by approximately \$29.9 million, and to increase net earned premiums by the same amount.

Earned but unbilled premiums increased \$2.2 million, or 295%, primarily due to the growth in the rate of audit premiums to original premiums written during 2006, recognition of increased audit premium collection experience, and growth in net retained earned premiums subject to premium audits.

Table of Contents***Commissions and Fees***

	Six Months Ended		
	June 30,		
	2007	2006	Change
	(Dollars in thousands)		
Insurance underwriting commissions and fees	\$ 3,935	\$ 3,044	29%
Insurance services commissions and fees	5,624	5,719	(2)
Total commissions and fees	\$ 9,559	\$ 8,763	9%

Insurance underwriting commissions and fees increased \$0.9 million, or 29%, from the six months ended June 30, 2006 to the six months ended June 30, 2007, principally due to increases in commissions on fronted premiums. Insurance services commissions and fees, which were principally ARPCO income and not related to premiums produced, decreased \$0.1 million, or 2%, principally as the result of increased claims handling fees of \$0.4 million offset by decreased brokerage fees income of \$0.5 million.

Net Investment Income and Realized Gains on Investments. During the six months ended June 30, 2007, net investment income earned was \$7.2 million, a \$2.9 million, or 68%, increase from \$4.3 million reported in the six months ended June 30, 2006 primarily due to the increase in invested assets over the period. At June 30, 2007, invested assets were \$395.9 million, a \$172.7 million, or 77%, increase over \$223.2 million of invested assets at June 30, 2006 due to increases in net written premiums, proceeds from our initial public and secondary offerings, proceeds from the issuance of trust preferred securities, cash received for the unearned premiums related to the 2006 50% quota share reinsurance contract terminated on a cut-off basis, and from the cash retained on our 35% quota share reinsurance contracts on a funds withheld basis. Net investment income earned continued to benefit from higher reinvestment rates as proceeds from maturing bonds were reinvested at currently higher interest rates. The annualized investment yield (net of investment expenses) was 4.0% and 3.7% at June 30, 2007 and June 30, 2006, respectively. The increase was the result of the general increase in market interest rates offset by increased allocation to municipal securities. The annualized tax equivalent yield on total investments was 4.8% and 4.4% at June 30, 2007 and 2006, respectively.

During the six months ended June 30, 2007 net realized gains on investments were \$0.8 million, a \$1.3 million increase over the net realized capital loss of \$0.5 million during the six months ended June 30, 2006. The net realized gains were principally due to sales of investment securities at gains of approximately \$0.7 million and mark to market increases of \$0.1 million in convertible bonds carried at market in accordance with SFAS 155.

Operating Expenses

Losses and Loss Adjustment Expenses. Losses and loss adjustment expenses incurred increased \$16.5 million, or 55%, in the six months ended June 30, 2007 compared to the six months ended June 30, 2006. Growth from the increase in net earned exposure growth reflected in the 56% net earned premiums growth and an increase in the accident year loss and loss adjustment expense ratio was offset by approximately \$0.9 million in favorable development of December 31, 2006 and prior years unallocated loss adjustment expense reserves in the six months ended June 30, 2007, as compared to the \$1.0 million in unfavorable loss and loss adjustment expense reserves development report of December 31, 2004 and prior reserves reported during the first six months of 2006.

Other Operating Expenses

	Six Months Ended		
	June 30,		
	2007	2006	Change
	(Dollars in thousands)		
Amortization of deferred acquisition expenses	\$ 16,296	\$ 9,092	79%
Ceded reinsurance commissions	(18,098)	(17,962)	1

Edgar Filing: FIRST MERCURY FINANCIAL CORP - Form 10-Q

Other underwriting and operating expenses	27,442	25,341	8
Other operating expenses	\$ 25,640	\$ 16,471	56%

25

Table of Contents

During the six months ended June 30, 2007, other operating expenses increased \$9.2 million, or 56%, from the six months ended June 30, 2006. Amortization of deferred acquisition expenses increased by \$7.2 million, or 79%, including a \$9.8 million increase related to the approximately \$29.9 million in net premiums earned due to the termination on a cut-off basis of the 2006 50% quota share reinsurance treaties on December 31, 2006 and by a decrease of \$2.5 million related to remaining net earned premiums during the six months ended June 30, 2007. Ceded reinsurance commissions increased \$0.1 million, or 1%, principally due to the increase in net written premiums and an increase in ceding commission rates, offset by the effect of purchasing 35% quota share reinsurance during the first quarter of 2007 compared to purchasing 50% quota share reinsurance during the first quarter of 2006. Other underwriting and operating expenses, which consist of commissions, other acquisition costs, and general and underwriting expenses, net of acquisition cost deferrals, increased by \$2.1 million, or 8%, principally due to an increase of \$1.8 million in commissions and other acquisition costs, net of acquisition cost deferrals, and an increase of \$0.3 million in general and underwriting expenses during the six months ended June 30, 2007.

Interest Expense

	Six Months Ended June 30,		
	2007	2006	Change
	(Dollars in thousands)		
Senior notes	\$	\$ 4,169	(100)%
Junior subordinated debentures	1,949	510	282
Other		330	(100)
Total interest expense	\$ 1,949	\$ 5,009	(61)%

Interest expense decreased \$3.1 million, or 61%, from the six months ended June 30, 2006 to the six months ended June 30, 2007. This decrease was principally attributable to a \$4.2 million decrease in interest expense related to the \$65.0 million senior notes issued in August 2005 and repaid in October 2006. This decrease was offset by a \$1.4 million increase in interest expense related to junior subordinated debentures of \$46.4 million and \$20.6 million at June 30, 2007 and 2006, respectively, which included the change in fair value of interest rate swap on junior subordinated debentures as discussed in Liquidity and Capital Resources.

Income taxes. Our effective tax rates were approximately 34.7% for the six months ended June 30, 2007 and June 30, 2006.

Liquidity and Capital Resources**Sources and Uses of Funds**

FMFC. FMFC is a holding company with all of its operations being conducted by its subsidiaries. Accordingly, FMFC has continuing cash needs for primarily administrative expenses, debt service and taxes. Funds to meet these obligations come primarily from management and administrative fees from all of our subsidiaries, and dividends from our non-insurance subsidiaries.

Insurance Subsidiaries. The primary sources of our insurance subsidiaries' cash are net written premiums, claims handling fees, amounts earned from investments and the sale or maturity of invested assets. Additionally, FMFC has in the past and may in the future contribute capital to its insurance subsidiaries.

The primary uses of our insurance subsidiaries' cash include the payment of claims and related adjustment expenses, underwriting fees and commissions and taxes and making investments. Because the payment of individual claims cannot be predicted with certainty, our insurance subsidiaries rely on our paid claims history and industry data in determining the expected payout of claims and estimated loss reserves. To the extent that FMIC and ANIC have an unanticipated shortfall in cash, they may either liquidate securities held in their investment portfolios or obtain capital from FMFC. However, given the cash generated by our insurance subsidiaries' operations and the relatively short duration of their investment portfolios, we do not currently foresee any such shortfall.

Non-insurance Subsidiaries. The primary sources of our non-insurance subsidiaries' cash are commissions and fees, policy fees, administrative fees and claims handling and loss control fees. The primary uses of our non-insurance subsidiaries' cash are commissions paid to brokers, operating expenses, taxes and dividends paid to FMFC. There are generally no restrictions on the payment of dividends by our non-insurance subsidiaries, except as may be set forth in our borrowing arrangements.

Table of Contents***Cash Flows***

Our sources of funds have consisted primarily of net written premiums, commissions and fees, investment income and proceeds from the issuance of equity securities and debt. We use operating cash primarily to pay operating expenses and losses and loss adjustment expenses and for purchasing investments. A summary of our cash flows is as follows:

	Six Months Ended June 30,	
	2007	2006
	(Dollars in thousands)	
Cash and cash equivalents provided by (used in):		
Operating activities	\$ 81,711	\$ 32,058
Investing activities	(101,224)	(20,657)
Financing activities	12,249	243
Change in cash and cash equivalents	\$ (7,264)	\$ 11,644

Net cash provided by operating activities for the six months ended June 30, 2007 was primarily from cash received on net written premiums and cash received for the unearned premiums related to the 2006 50% quota share reinsurance contract terminated on a cut-off basis on December 31, 2006 less cash disbursed for operating expenses and losses and loss adjustment expenses. Net cash provided by operating activities for the six months ended June 30, 2006 was primarily from cash received on net written premiums, less cash disbursed for operating expenses and losses and loss adjustment expenses. Cash received from net written premiums for the six months ended June 30, 2007 were retained on a funds withheld basis in accordance with the Company's 35% quota share reinsurance contracts resulting in increased net cash flow provided by operations compared to the six months ended June 30, 2006.

Net cash used in investing activities for the six months ended June 30, 2007 and 2006 primarily resulted from our net investment in short-term, debt and equity securities. The \$80.6 million increase in net cash used in investing activities for the six months ended June 30, 2007 compared to the six months ended June 30, 2006 was principally a result of increased net cash flow provided by operating activities as described above as well as the investment of proceeds from a follow-on common stock offering on June 14, 2007, which is discussed in more detail below.

Net cash provided by financing activities for the six months ended June 30, 2007 resulted from the issuance of common stock in a secondary offering discussed below.

Based on historical trends, market conditions, and our business plans, we believe that our existing resources and sources of funds will be sufficient to meet our liquidity needs in the foreseeable future. Because economic, market and regulatory conditions may change, however, there can be no assurances that our funds will be sufficient to meet our liquidity needs. In addition, competition, pricing, the frequency and severity of losses, and interest rates could significantly affect our short-term and long-term liquidity needs.

Follow-on stock offering

We completed a follow-on offering of common stock on June 27, 2007 in which we sold 695,189 shares of common stock for net proceeds of \$12.2 million. This amount included 495,189 shares of common stock sold to the underwriters of the offering pursuant to the underwriters' exercise of their over-allotment option.

Long-term debt

Junior Subordinated Debentures. We have \$46.4 million cumulative principal amount of floating rate junior subordinated debentures outstanding, \$25.8 million of which were issued in December 2006. The debentures were issued in connection with the issuance of trust preferred stock by our wholly-owned, non-consolidated trusts. Cumulative interest on the cumulative principal amount of the debentures is payable quarterly in arrears at a variable annual rate, reset quarterly, equal to the three month LIBOR plus 3.75% for \$8.2 million, the three month LIBOR plus 4.00% for \$12.4 million, and the three month LIBOR plus 3.0% for \$25.8 million principal amount of the debentures. At June 30, 2007, the three month LIBOR rate was 5.36%. We may defer the payment of interest for up to 20

consecutive quarterly periods; however, no such deferral has been made or are expected.

Table of Contents

Credit Facility. In October 2006, we entered into a credit facility which provided for borrowings of up to \$30.0 million. Borrowings under the credit facility bear interest at our election as follows: (i) at a rate per annum equal to the greater of the lender's prime rate and the federal funds rate less 0.5%, each minus 0.75%; or, (ii) a rate per annum equal to LIBOR plus an applicable margin which is currently 0.75% or 1.0% based on our leverage ratio. The obligations under the credit facility are guaranteed by our material non-insurance subsidiaries. The maturity date of borrowings made under the credit facility is September 2011. The credit facility contains covenants which, among other things, restrict our ability to incur indebtedness, grant liens, make investments and sell assets. The credit facility also has certain financial covenants. There are currently no borrowings under the agreement. We are not required to comply with the financial-related covenants until we borrow under the credit facility.

Derivative Financial Instruments. Financial derivatives are used as part of the overall asset and liability risk management process. We use interest rate swap agreements with a combined notional amount of \$45.0 million in order to reduce our exposure to interest rate fluctuations with respect to our junior subordinated debentures. Under two of our swap agreements, which expire in August 2009, we pay interest at a fixed rate of 4.12%; under our other swap agreement, which expires in December 2011, we pay interest at a fixed rate of 5.013%. Under all three swap agreements, we receive interest at the three month LIBOR, which is equal to the contractual rate under the junior subordinated debentures. At June 30, 2007, we had minimal exposure to credit loss on the interest rate swap agreements.

Cash and Invested Assets

Our cash and invested assets consist of fixed maturity securities, convertible securities, and cash and cash equivalents. At June 30, 2007, our investments had a market value of \$395.9 million and consisted of the following investments:

	June 30, 2007	
	Market Value	% of Portfolio
	(Dollars in thousands)	
Money Market Funds	\$ 64,500	16.3%
Treasury Securities	8,345	2.1%
Agency Securities	719	0.2%
Corp / Preferred	38,542	9.7%
Municipal Bonds	171,952	43.4%
Asset backed Securities	42,794	10.8%
Mortgages	39,263	9.9%
Convertible Securities	29,728	7.5%
Other	11	0.1%
Total	\$ 395,854	100.0%

The following table shows the composition of the investment portfolio by remaining time to maturity at June 30, 2007. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Additionally, the expected maturities of our investments in putable bonds fluctuate inversely with interest rates and therefore may also differ from contractual maturities.

Average Life	% of Total Investment
Less than one year	26.6%
One to two years	9.5%
Two to three years	12.0%
Three to four years	18.5%

Four to five years	13.9%
Five to seven years	10.3%
More than seven years	9.2%
Total	100.0%

Table of Contents

The effective duration of the portfolio as of June 30, 2007 is approximately 2.8 years and the tax-effected duration was 2.4 years. Excluding cash and convertible securities the portfolio duration and tax-effected duration are 3.5 years and 3.0 years, respectively. The shorter tax-effected duration reflects the significant portion of the portfolio in municipal securities. The annualized investment yield (net of investment expenses) on total investments was 4.0% and 3.7% at June 30, 2007 and 2006, respectively. The increase was the result of higher reinvestment and tax equivalent yields on new purchases versus maturing bonds offset somewhat by increased allocation to municipal securities. The annualized tax equivalent yield on total investments was 4.8% and 4.4% at June 30, 2007 and 2006, respectively.

The majority of our portfolio consists of AAA or AA rated securities with a Standard and Poor's weighted average credit quality for our aggregate fixed income portfolio of AA+ at June 30, 2007. The majority of the investments rated BBB and below is convertible securities. Consistent with our investment policy, we review any security if it falls below BBB- and assess whether it should be held or sold. The following table shows the ratings distribution of our fixed income portfolio as of June 30, 2007 as a percentage of total market value.

S&P Rating	% of Total Investments
AAA	77.3%
AA	8.1%
A	8.3%
BBB	5.1%
BB	0.9%
B	0.2%
CCC	0.1%
NR	0.0%
Total	100.0%

Cash and cash equivalents consisted of cash on hand of \$7.1 million at June 30, 2007.

At June 30, 2007 the total unrealized loss of all impaired securities totaled \$4.9 million. This represents approximately 1.2% of invested assets of \$395.9 million at June 30, 2007.

For the six months ended June 30, 2007, we sold approximately \$8.1 million of market value of securities, which were trading below amortized cost while recording a realized loss of \$0.1 million. This loss represented 0.4% of the amortized cost of the positions. We sold Treasury issues to purchase other securities. We also sold some isolated positions of agencies, corporate, asset backed securities and municipal bonds. These sales were unique opportunities to sell specific positions due to changing market conditions. These situations were exceptions to our general assertion regarding our ability and intent to hold securities with unrealized losses until they mature or recover in value. This position is further supported by the insignificant losses as a percentage of amortized cost for the respective periods.

Deferred Policy Acquisition Costs

We defer a portion of the costs of acquiring insurance business, primarily commissions and certain policy underwriting and issuance costs, which vary with and are primarily related to the production of insurance business. For the six months ended June 30, 2007, \$10.3 million of the costs were deferred. Deferred policy acquisition costs totaled \$12.5 million, or 16.9%, of unearned premiums (net of reinsurance), at June 30, 2007.

On December 31, 2006 we elected the cut-off termination option available to us on the expiration of our 50% quota share contracts expiring that day in accordance with the termination provision of the quota share contracts. As a result, we effectively eliminated the 50% quota share reinsurance on the December 31, 2006 unearned premiums that had been ceded 50% up until contract expiration. The amount of the previously ceded net unearned premium reserve that was returned to the Company as a result of the cut-off termination election was \$39.6 million at December 31, 2006. As those premiums are earned during 2007, they will be reported in the Company's net earned premiums. At December 31, 2006 we recorded the related \$12.8 million in ceded commissions as deferred acquisition costs, of which \$3.1 million remained at June 30, 2007 to be amortized during the remainder of 2007 as related unearned

premiums are earned.

Table of Contents***Reinsurance***

The following table illustrates our direct written premiums and premiums ceded for the six months ended June 30, 2007 and 2006:

	Six Months Ended June 30,	
	2007	2006
	(Dollars in thousands)	
Direct written premiums	\$ 133,551	\$ 110,980
Ceded written premiums	59,381	59,305
Net written premiums	\$ 74,170	\$ 51,675
Ceded written premiums as percentage of direct written premiums	44.5%	53.4%

The following table illustrates the effect of our reinsurance ceded strategies on our results of operations:

	Six Months Ended June 30,	
	2007	2006
	(Dollars in thousands)	
Ceded written premiums	\$59,381	\$59,305
Ceded premiums earned	28,474	45,876
Losses and loss adjustment expenses ceded	14,282	23,979
Ceding commissions	8,365	14,350

Our net cash flows relating to ceded reinsurance activities (premiums paid less losses recovered and ceding commissions received) were approximately \$37.5 million net cash paid for the six months ended June 30, 2007 compared to net cash paid of \$39.7 million for the six months ended June 30, 2006.

The assuming reinsurer is obligated to indemnify the ceding company to the extent of the coverage ceded. The inability to recover amounts due from reinsurers could result in significant losses to us. To protect us from reinsurance recoverable losses, FMIC seeks to enter into reinsurance agreements with financially strong reinsurers. Our senior executives evaluate the credit risk of each reinsurer before entering into a contract and monitor the financial strength of the reinsurer. On June 30, 2007, substantially all of our reinsurance contracts to which we were a party were with companies with A.M. Best ratings of A or better. One reinsurance contract to which we were a party was with an unauthorized reinsurer for which we required full collateralization of our recoverable via a grantor trust and an irrevocable letter of credit. In addition, ceded reinsurance contracts contain trigger clauses through which FMIC can initiate cancellation including immediate return of all ceded unearned premiums at its option, or which result in immediate collateralization of ceded reserves by the assuming company in the event of a financial strength rating downgrade, thus limiting credit exposure. On June 30, 2007, there was no allowance for uncollectible reinsurance, as all reinsurance balances were current and there were no disputes with reinsurers.

On June 30, 2007 and December 31, 2006, FMFC had a net amount of recoverables from reinsurers of \$120.5 million and \$99.6 million, respectively, on a consolidated basis.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (*SFAS 157*), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the potential impact that the adoption of SFAS No. 157 will have on its financial statements.

Table of Contents

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (*SFAS 159*), which provides reporting entities an option to report selected financial assets, including investment securities designated as available for sale, and liabilities, including most insurance contracts, at fair value. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The standard also requires additional information to aid financial statement users' understanding of a reporting entity's choice to use fair value on its earnings and also requires entities to display on the face of the balance sheet the fair value of those assets and liabilities for which the reporting entity has chosen to measure at fair value. SFAS 159 is effective as of the beginning of a reporting entity's first fiscal year beginning after November 15, 2007. The Company has not elected the early adoption provisions of this standard. Because application of the standard is optional, any impacts are limited to those financial assets and liabilities to which SFAS 159 would be applied, which has yet to be determined, as is any decision concerning the early adoption of the standard.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2006 for a complete discussion of the Company's market risk. There have been no material changes to the market risk information included in the Company's Annual Report on Form 10-K.

Item 4. Controls and Procedures

The Company's chief executive officer and chief financial officer have concluded, based on their evaluation as of the end of the period covered by this report, that the Company's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) are effective to ensure that information required to be disclosed in the reports that the Company files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding financial disclosures. There was no change in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2007 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 4. Submission of Matters to a Vote of Security Holders

On May 9, 2007, the Company held its annual meeting of stockholders at which stockholders:

- (i) elected to the Board of Directors of First Mercury Financial Corporation seven directors; and
- (ii) ratified the appointment of BDO Seidman, LLP as independent registered public accounting firm for the Company for the year ending December 31, 2007.

Voting results were as follows:

(i)

Director Nominee	Votes For	Votes Withheld
Steven A. Shapiro	15,878,794	699,793
Jerome M. Shaw	11,327,775	5,250,812
Richard H. Smith	15,706,013	872,574
Thomas Kearney	15,879,094	699,493
William C. Tyler	15,879,094	699,493
Louis J. Manetti	11,185,175	5,393,412
Hollis W. Rademacher	16,315,574	263,013

(ii)

	For	Against	Abstain
Ratification of appointment of BDO Seidman, LLP	16,521,237	53,422	3,928

Item 6. Exhibits

See Index of Exhibits following the signature page, which is incorporated herein by reference.

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.

FIRST MERCURY FINANCIAL
CORPORATION

By: /s/ RICHARD H. SMITH
Richard H. Smith
*Chairman, President and Chief
Executive Officer*

By: /s/ JOHN A. MARAZZA
John A. Marazza
*Executive Vice President, Chief
Financial Officer and Treasurer*

Date: August 8, 2007

33

Table of Contents

INDEX OF EXHIBITS

Exhibit Number	Note	Description
31 (a)	(1)	Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934
31 (b)	(1)	Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934
32 (a)	(1)	Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350 and Rule 13a-14(b) of the Securities Exchange Act of 1934
32 (b)	(1)	Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350 and Rule 13a-14(b) of the Securities Exchange Act of 1934

(1) - Filed herewith