

KINGSWAY FINANCIAL SERVICES INC  
Form 10-Q  
May 08, 2014

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

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FORM 10-Q  
(Mark One)

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

March 31, 2014

or  
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2014

Commission File Number: 001-15204

Kingsway Financial Services Inc.  
(Exact name of registrant as specified in its charter)

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Ontario, Canada

(State or other jurisdiction of  
incorporation or organization)

Not Applicable (I.R.S. Employer  
Identification No.)

45 St. Clair Avenue West, Suite 400 Toronto, Ontario M4V 1K9

(Address of principal executive offices and zip code)

1-416-848-1171

(Registrant's telephone number, including area code)

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Indicate by checkmark 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T ( 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer   
(Do not check if a smaller reporting company) Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The number of shares outstanding of the registrant's common stock as of May 8, 2014 was 16,429,761.

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KINGSWAY FINANCIAL SERVICES INC.

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## KINGSWAY FINANCIAL SERVICES INC.

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## Consolidated Balance Sheets

(in thousands, except per share data)

|  | March 31, 2014<br>(unaudited) | December 31,<br>2013 |
|--|-------------------------------|----------------------|
| Assets   |                               |                      |
| Investments:   |                               |                      |
| Fixed maturities, at fair value (amortized cost of \$50,778 and \$53,455, respectively)          | \$51,456                      | \$54,151             |
| Equity investments, at fair value (cost of \$5,103 and \$3,554, respectively)                    | 9,982                         | 7,137                |
| Limited liability investments  | 4,701                         | 4,406                |
| Other investments, at cost which approximates fair value   | 2,000                         | 3,000                |
| Short-term investments, at cost which approximates fair value                                    | 401                           | 501                  |
| Total investments  | 68,540                        | 69,195               |
| Cash and cash equivalents  | 72,080                        | 98,589               |
| Investment in investee   | 7,661                         | —                    |
| Accrued investment income  | 1,096                         | 614                  |
| Premiums receivable, net of allowance for doubtful accounts of \$1,839 and \$2,123, respectively | 32,609                        | 32,035               |
| Service fee receivable, net of allowance for doubtful accounts of \$245 and \$0, respectively    | 22,622                        | 19,012               |
| Other receivables, net of allowance for doubtful accounts of \$1,061 and \$1,062, respectively   | 5,106                         | 4,097                |
| Reinsurance recoverable  | 7,569                         | 10,335               |
| Prepaid reinsurance premiums   | 148                           | 6,816                |
| Deferred acquisition costs, net  | 12,559                        | 12,392               |
| Property and equipment, net of accumulated depreciation of \$15,894 and \$15,848, respectively   | 1,671                         | 1,662                |
| Goodwill   | 10,588                        | 10,588               |
| Intangible assets, net of accumulated amortization of \$18,997 and \$18,583, respectively        | 48,504                        | 48,918               |
| Other assets   | 3,525                         | 4,039                |
| Asset held for sale  | 6,347                         | 6,347                |
| Total Assets   | \$300,625                     | \$324,639            |
| Liabilities and Shareholders' Equity   |                               |                      |
| Liabilities:   |                               |                      |
| Unpaid loss and loss adjustment expenses:  |                               |                      |
| Property and casualty  | \$77,285                      | \$84,534             |
| Vehicle service agreements   | 3,128                         | 3,128                |
| Total unpaid loss and loss adjustment expenses   | 80,413                        | 87,662               |
| Unearned premiums  | 40,979                        | 48,577               |
| Reinsurance payable  | 145                           | 1,033                |
| LROC preferred units, at fair value  | 14,291                        | 14,854               |
| Senior unsecured debentures, at fair value   | —                             | 14,356               |

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|   |           |            |
|---|-----------|------------|
| Subordinated debt, at fair value  | 28,471    | 28,471     |
| Deferred income tax liability   | 4,456     | 4,173      |
| Deferred service fees   | 49,262    | 48,788     |
| Income taxes payable  | 921       | 2,984      |
| Accrued expenses and other liabilities  | 37,538    | 36,821     |
| Total Liabilities   | \$256,476 | \$287,719  |
| Shareholders' Equity:   |           |            |
| Class A preferred stock, no par value; unlimited number authorized; 262,876 and zero issued and outstanding at March 31, 2014 and December 31, 2013, respectively | \$6,402   | \$—        |
| Common stock, no par value; unlimited number authorized; 16,429,761 and 16,429,761 issued and outstanding at March 31, 2014 and December 31, 2013, respectively   | —         | —          |
| Additional paid-in capital  | 325,427   | 324,803    |
| Accumulated deficit   | (300,640  | ) (298,930 |
| Accumulated other comprehensive income  | 10,973    | 9,601      |
| Shareholders' equity attributable to common shareholders  | 42,162    | 35,474     |
| Noncontrolling interests in consolidated subsidiaries   | 1,987     | 1,446      |
| Total Shareholders' Equity  | 44,149    | 36,920     |
| Total Liabilities and Shareholders' Equity  | \$300,625 | \$324,639  |
| See accompanying notes to unaudited consolidated financial statements.  |           |            |

## KINGSWAY FINANCIAL SERVICES INC.

Consolidated Statements of Operations  
(in thousands, except per share data)  
(Unaudited)

|   | Three months ended March 31, |            |
|---|------------------------------|------------|
|   | 2014                         | 2013       |
| Revenues:   |                              |            |
| Net premiums earned   | \$31,920                     | \$28,068   |
| Service fee and commission income   | 14,724                       | 13,124     |
| Net investment income   | 413                          | 580        |
| Net realized gains (losses)   | 39                           | (1,409)    |
| Other income  | 2,071                        | 2,218      |
| Total revenues  | 49,167                       | 42,581     |
| Expenses:   |                              |            |
| Loss and loss adjustment expenses   | 21,061                       | 21,831     |
| Commissions and premium taxes   | 6,553                        | 6,712      |
| Cost of services sold   | 856                          | —          |
| General and administrative expenses   | 18,524                       | 19,604     |
| Restructuring expense   | 20                           | 780        |
| Interest expense  | 1,433                        | 1,833      |
| Amortization of intangible assets   | 414                          | 558        |
| Contingent consideration expense  | 267                          | 155        |
| Total expenses  | 49,128                       | 51,473     |
| Income (loss) before gain (loss) on change in fair value of debt, loss on disposal of subsidiary, loss on buy-back of debt, equity in net income of investee and income tax expense (benefit) | 39                           | (8,892)    |
| Gain (loss) on change in fair value of debt   | 563                          | (8,951)    |
| Loss on disposal of subsidiary  | (1,242)                      | —          |
| Loss on buy-back of debt  | —                            | (24)       |
| Equity in net income of investee  | —                            | 255        |
| Loss before income tax expense (benefit)  | (640)                        | (17,612)   |
| Income tax expense (benefit)  | 366                          | (276)      |
| Net loss  | (1,006)                      | (17,336)   |
| Less: net income attributable to noncontrolling interests in consolidated subsidiaries  | 653                          | 95         |
| Less: dividends on preferred stock  | 53                           | —          |
| Net loss attributable to common shareholders  | \$(1,712)                    | \$(17,431) |
| Loss per share – net loss attributable to common shareholders:  |                              |            |
| Basic:  | \$ (0.10)                    | \$ (1.33)  |
| Diluted:  | (0.10)                       | (1.33)     |
| Weighted average shares outstanding (in '000s):   |                              |            |
| Basic:  | 16,430                       | 13,149     |
| Diluted:  | 16,430                       | 13,149     |

See accompanying notes to unaudited consolidated financial statements.

## KINGSWAY FINANCIAL SERVICES INC.

Consolidated Statements of Comprehensive Income (Loss)  
(in thousands)  
(unaudited)

|  | Three months ended March 31, |           |
|--|------------------------------|-----------|
|  | 2014                         | 2013      |
| Net loss   | \$(1,006                     | \$(17,336 |
| Other comprehensive income (loss), net of taxes <sup>(1)</sup> :                                 |                              |           |
| Unrealized gains (losses) on fixed maturities and equity investments:                            |                              |           |
| Unrealized gains (losses) arising during the period  | 1,226                        | (503      |
| Reclassification adjustment for amounts included in net loss                                     | 52                           | 248       |
| Foreign currency translation adjustments   | (18                          | 1         |
| Equity in other comprehensive loss of investee   | —                            | (105      |
| Other comprehensive income (loss)  | 1,260                        | (359      |
| Comprehensive income (loss)  | 254                          | (17,695   |
| Less: comprehensive income attributable to noncontrolling interests in consolidated subsidiaries | 541                          | 66        |
| Comprehensive loss attributable to common shareholders   | \$(287                       | \$(17,761 |

(1) Net of income tax expense (benefit) of \$0 and \$0 for the three months ended March 31, 2014 and March 31, 2013, respectively.

See accompanying notes to unaudited consolidated financial statements

## KINGSWAY FINANCIAL SERVICES INC.

## Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

|   | Three months ended March 31, |             |
|---|------------------------------|-------------|
|   | 2014                         | 2013        |
| Cash provided by (used in):   |                              |             |
| Operating activities:   |                              |             |
| Net loss  | \$(1,006                     | ) \$(17,336 |
| Adjustments to reconcile net loss to net cash used in operating activities: |                              |             |
| Equity in net income of investee  | —                            | (255        |
| Equity in net income of limited liability investments                       | (22                          | ) (50       |
| Depreciation and amortization   | 693                          | 1,002       |
| Contingent consideration expense  | 267                          | 155         |
| Stock based compensation expense, net of forfeitures                        | 624                          | —           |
| Net realized (gains) losses   | (39                          | ) 1,409     |
| (Gain) loss on change in fair value of debt                                 | (563                         | ) 8,951     |
| Deferred income taxes   | 459                          | (416        |
| Amortization of fixed maturities premiums and discounts                     | 206                          | 1,270       |
| Loss on disposal of subsidiary  | 1,242                        | —           |
| Realized loss on buy-back of debt   | —                            | 24          |
| Changes in operating assets and liabilities:                                |                              |             |
| Premiums and service fee receivable   | (4,184                       | ) (6,086    |
| Reinsurance recoverable   | 2,766                        | (6,108      |
| Prepaid reinsurance premiums  | 6,668                        | (2,922      |
| Deferred acquisition costs  | (167                         | ) 1,417     |
| Unpaid loss and loss adjustment expenses                                    | (7,249                       | ) (5,360    |
| Unearned premiums   | (7,598                       | ) 7,069     |
| Reinsurance payable   | (888                         | ) 5,681     |
| Deferred service fees   | 474                          | (174        |
| Other, net  | (623                         | ) 470       |
| Net cash used in operating activities                                       | (8,940                       | ) (11,259   |
| Investing activities:   |                              |             |
| Proceeds from sales and maturities of fixed maturities                      | 5,100                        | 9,348       |
| Proceeds from sales of equity investments                                   | 71                           | 175         |
| Proceeds from sales of investment in investee                               | —                            | 13,638      |
| Purchase of fixed maturities  | (5,878                       | ) (879      |
| Purchase of equity investments  | (1,593                       | ) (23       |
| Net acquisition of limited liability investments                            | (263                         | ) 99        |
| Proceeds from other investments   | 1,000                        | —           |
| Net purchases of short-term investments                                     | (103                         | ) (325      |
| Acquisition of investee   | (7,661                       | ) —         |
| Net purchases of property and equipment                                     | (288                         | ) (183      |
| Net cash (used in) provided by investing activities                         | (9,615                       | ) 21,850    |
| Financing activities:   |                              |             |
| Proceeds from issuance of preferred stock, net                              | 6,402                        | —           |
| Redemption of senior unsecured debentures                                   | (14,356                      | ) (583      |
| Net cash used in financing activities                                       | (7,954                       | ) (583      |
| Net (decrease) increase in cash and cash equivalents                        | (26,509                      | ) 10,008    |
| Cash and cash equivalents at beginning of period                            | 98,589                       | 80,813      |



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|  |          |          |
|--|----------|----------|
| Cash and cash equivalents at end of period | \$72,080 | \$90,821 |
|--|----------|----------|

See accompanying notes to unaudited consolidated financial statements.

KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

NOTE 1 BUSINESS

Kingsway Financial Services Inc. (the "Company" or "Kingsway") was incorporated under the Business Corporations Act (Ontario) on September 19, 1989. Kingsway is a Canadian holding company with operating subsidiaries located in the United States. The Company operates as a merchant bank primarily engaged, through its subsidiaries, in the property and casualty insurance business.

NOTE 2 BASIS OF PRESENTATION

The accompanying unaudited consolidated interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements of the Company. In the opinion of management, all adjustments necessary for a fair presentation have been included and are of a normal recurring nature. Interim results are not necessarily indicative of the results that may be expected for the year.

The accompanying unaudited consolidated interim financial statements and footnotes should be read in conjunction with the audited consolidated financial statements and footnotes included within our Annual Report on Form 10-K ("2013 Annual Report") for the year ended December 31, 2013.

The unaudited consolidated interim financial statements include the accounts of the Company and its subsidiaries. All material intercompany transactions and balances have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect application of policies and the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from these estimates. Estimates and their underlying assumptions are reviewed on an ongoing basis. Changes in estimates are recorded in the accounting period in which they are determined. The critical accounting estimates and assumptions in the accompanying unaudited consolidated interim financial statements include the provision for unpaid loss and loss adjustment expenses, valuation of fixed maturities and equity investments, valuation of deferred income taxes, valuation of intangible assets, goodwill recoverability, deferred acquisition costs, fair value assumptions for debt obligations and contingent consideration.

The fair values of the Company's investments in fixed maturities and equity investments, LROC preferred units, senior unsecured debentures, subordinated debt and contingent consideration are estimated using a fair value hierarchy to categorize the inputs it uses in valuation techniques. Fair values for other investments approximate their unpaid principal balance. The carrying amounts reported in the consolidated balance sheets approximate fair values for cash, short-term investments and certain other assets and other liabilities because of their short-term nature.

The Company's financial results contained herein are reported in U.S. dollars unless otherwise indicated.

NOTE 3 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

There have been no material changes to our significant accounting policies as reported in our 2013 Annual Report.

NOTE 4 RECENTLY ISSUED ACCOUNTING STANDARDS

In July 2012, the FASB issued ASU 2012-02, Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment ("ASU 2012-02"). ASU 2012-02 provides entities with an option to first assess qualitative factors to determine whether events or circumstances indicate that it is more likely than not that the indefinite-lived intangible asset is impaired. If an entity concludes that it is more than 50% likely that an indefinite-lived intangible asset is not impaired, no further analysis is required. However, if an entity concludes otherwise, it would be required to determine the fair value of the indefinite-lived intangible asset to measure the amount of actual impairment, if any, as currently required under US GAAP. Effective January 1, 2013, the Company adopted ASU 2012-02 and the adoption did not have an impact on the consolidated financial statements. There have been no triggering events that would suggest possible impairment or that it is more-likely-than-not that the fair values of indefinite-lived intangible assets are less than their carrying amounts.

In February 2013, the FASB issued ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income ("ASU 2013-02"), which is intended to improve the reporting of reclassifications out of accumulated other comprehensive income. The ASU requires an entity to report, either on the face of the income statement or in the notes to the financial statements, the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in the income

KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

statement if the amount being reclassified is required to be reclassified in its entirety to net income. For other amounts that are not required to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other required disclosures that provide additional detail about those amounts. Effective January 1, 2013, the Company adopted ASU 2013-02. Except for the new disclosure requirements, the adoption of the standard did not have an impact on the consolidated financial statements. The required disclosures are included in Note 17, "Accumulated Other Comprehensive Income."

In July 2013, the FASB issued ASU 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists ("ASU 2013-11"). ASU 2013-11 amends ASC Topic 740, Income Taxes, to provide guidance and reduce diversity in practice on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. Effective January 1, 2014, the Company adopted ASU 2013-11. Except for the new disclosure requirements, the adoption of the standard did not have an impact on the consolidated financial statements.

#### NOTE 5 ACQUISITION AND DISPOSITION

##### (a) Acquisition

Trinity Warranty Solutions LLC:

Effective May 22, 2013, the Company's subsidiary, Trinity Warranty Solutions LLC ("Trinity"), acquired certain intangible assets and liabilities of Trinity Warranty Corp. for total consideration consisting of approximately \$1.1 million in cash and future contingent payments. As further discussed in Note 18, "Segmented Information," Trinity is included in the Insurance Services segment. Trinity is based in Illinois and is a provider of warranty products and maintenance support to consumers and businesses in the heating, ventilation, air conditioning ("HVAC") and refrigeration industry.

This acquisition was accounted for as a business combination using the purchase method of accounting. The purchase price was allocated to the assets purchased and liabilities assumed based upon their estimated fair values at the date of acquisition. During the fourth quarter of 2013, the Company completed its fair value analysis on the assets acquired and liabilities assumed. Goodwill of \$1.1 million was recognized in addition to \$0.5 million of a separately identifiable intangible asset for customer-related relationships. Refer to Note 9, "Intangible Assets," for further disclosure on intangible assets related to this acquisition. The fair value analysis performed resulted in the establishment of a \$0.6 million liability effective May 22, 2013 related to present value of future contingent payments. The maximum the Company can pay in future contingent payments is \$2.4 million, on an undiscounted basis. The contingent payments are payable annually beginning in 2014 through 2023, are subject to the achievement of certain targets and may be adjusted in future periods based on actual performance achieved. As of March 31, 2014, the recorded value of the contingent payment liability is \$0.8 million, which is included in accrued expenses and other liabilities on the consolidated balance sheets.

##### (b) Disposition

Effective March 31, 2014, the Company's wholly owned subsidiary, 1347 Property Insurance Holdings, Inc. ("PIH"), formerly known as Maison Insurance Holdings, Inc., completed an initial public offering of its common stock. Total consideration to the Company as a result of this transaction was \$7.7 million, consisting of a 28.7% interest in the common shares of PIH. As a result of the disposal, the Company recognized a loss of \$1.2 million for the three months ended March 31, 2014. The earnings of PIH are included in the consolidated statements of operations through the March 31, 2014 transaction date. Refer to Note 7, "Investment in Investee," for further disclosure on the Company's investment in PIH at March 31, 2014.



## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

## NOTE 6 INVESTMENTS

The amortized cost, gross unrealized gains and losses, and estimated fair value of the Company's investments in fixed maturities and equity investments at March 31, 2014 and December 31, 2013 are summarized in the tables shown below:

| (in thousands)  | March 31, 2014    |                        |                         |                      |
|---|-------------------|------------------------|-------------------------|----------------------|
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Fixed maturities:   |                   |                        |                         |                      |
| U.S. government, government agencies and authorities            | \$ 15,255         | \$ 531                 | \$ 21                   | \$ 15,765            |
| Canadian government   | 4,417             | —                      | 161                     | 4,256                |
| States municipalities and political subdivisions                | 6,118             | 138                    | —                       | 6,256                |
| Mortgage-backed   | 1,952             | 16                     | 1                       | 1,967                |
| Asset-backed securities and collateralized mortgage obligations | 4,489             | 4                      | 2                       | 4,491                |
| Corporate   | 18,547            | 184                    | 10                      | 18,721               |
| Total fixed maturities  | 50,778            | 873                    | 195                     | 51,456               |
| Equity investments:   |                   |                        |                         |                      |
| Common stock  | 5,103             | 4,972                  | 93                      | 9,982                |
| Total fixed maturities and equity investments                   | \$ 55,881         | \$ 5,845               | \$ 288                  | \$ 61,438            |
| (in thousands)  | December 31, 2013 |                        |                         |                      |
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Fixed maturities:   |                   |                        |                         |                      |
| U.S. government, government agencies and authorities            | \$ 17,777         | \$ 591                 | \$ 30                   | \$ 18,338            |
| Canadian government   | 4,235             | —                      | 153                     | 4,082                |
| States municipalities and political subdivisions                | 6,126             | 105                    | —                       | 6,231                |
| Mortgage-backed   | 1,993             | 15                     | 2                       | 2,006                |
| Asset-backed securities and collateralized mortgage obligations | 3,996             | 1                      | 3                       | 3,994                |
| Corporate   | 19,328            | 183                    | 11                      | 19,500               |
| Total fixed maturities  | 53,455            | 895                    | 199                     | 54,151               |
| Equity investments:   |                   |                        |                         |                      |
| Common stock  | 3,554             | 3,623                  | 40                      | 7,137                |
| Total fixed maturities and equity investments                   | \$ 57,009         | \$ 4,518               | \$ 239                  | \$ 61,288            |

The table below summarizes the Company's fixed maturities at March 31, 2014 by contractual maturity periods. Actual results may differ as issuers may have the right to call or prepay obligations, with or without penalties, prior to the contractual maturity of these obligations.

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

| (in thousands)                         | March 31, 2014 |                      |
|--|----------------|----------------------|
|  | Amortized Cost | Estimated Fair Value |
| Due in one year or less                | \$17,500       | \$17,596             |
| Due after one year through five years  | 30,733         | 31,296               |
| Due after five years through ten years | 614            | 619                  |
| Due after ten years                    | 1,931          | 1,945                |
| Total                                  | \$50,778       | \$51,456             |

The following tables highlight the aggregate unrealized loss position, by security type, of fixed maturities and equity investments in unrealized loss positions as of March 31, 2014 and December 31, 2013. The tables segregate the holdings based on the period of time the investments have been continuously held in unrealized loss positions.

| (in thousands)  | March 31, 2014       |                 |                        |                 |                      |                 |
|---|----------------------|-----------------|------------------------|-----------------|----------------------|-----------------|
|   | Less than 12 Months  |                 | Greater than 12 Months |                 | Total                |                 |
|   | Estimated Fair Value | Unrealized Loss | Estimated Fair Value   | Unrealized Loss | Estimated Fair Value | Unrealized Loss |
| Fixed maturities:   |                      |                 |                        |                 |                      |                 |
| U.S. government, government agencies and authorities            | \$2,514              | \$19            | \$861                  | \$2             | \$3,375              | \$21            |
| Canadian government   | —                    | —               | 4,256                  | 161             | 4,256                | 161             |
| Mortgage-backed   | 603                  | 1               | —                      | —               | 603                  | 1               |
| Asset-backed securities and collateralized mortgage obligations | 1,273                | 2               | —                      | —               | 1,273                | 2               |
| Corporate   | 816                  | 10              | —                      | —               | 816                  | 10              |
| Total fixed maturities  | 5,206                | 32              | 5,117                  | 163             | 10,323               | 195             |
| Equity investments:   |                      |                 |                        |                 |                      |                 |
| Common stock  | 1,618                | 93              | —                      | —               | 1,618                | 93              |
| Total   | \$6,824              | \$125           | \$5,117                | \$163           | \$11,941             | \$288           |

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

| (in thousands)  |                         |                    |                         |                    | December 31, 2013       |                    |
|---|-------------------------|--------------------|-------------------------|--------------------|-------------------------|--------------------|
|   | Less than 12 Months     |                    | Greater than 12 Months  |                    | Total                   |                    |
|   | Estimated<br>Fair Value | Unrealized<br>Loss | Estimated<br>Fair Value | Unrealized<br>Loss | Estimated<br>Fair Value | Unrealized<br>Loss |
| Fixed maturities:   |                         |                    |                         |                    |                         |                    |
| U.S. government, government agencies and authorities            | \$4,008                 | \$30               | \$—                     | \$—                | \$4,008                 | \$30               |
| Canadian government   | —                       | —                  | 4,082                   | 153                | 4,082                   | 153                |
| Mortgage-backed   | 919                     | 2                  | —                       | —                  | 919                     | 2                  |
| Asset-backed securities and collateralized mortgage obligations | 3,474                   | 3                  | —                       | —                  | 3,474                   | 3                  |
| Corporate   | 408                     | 1                  | —                       | 10                 | 408                     | 11                 |
| Total fixed maturities  | 8,809                   | 36                 | 4,082                   | 163                | 12,891                  | 199                |
| Equity investments:   |                         |                    |                         |                    |                         |                    |
| Common stock  | 969                     | 35                 | 1                       | 5                  | 970                     | 40                 |
| Total   | \$9,778                 | \$71               | \$4,083                 | \$168              | \$13,861                | \$239              |

Fixed maturities and equity investments contain approximately 18 and 27 individual investments that were in unrealized loss positions as of March 31, 2014 and December 31, 2013, respectively.

The establishment of an other-than-temporary impairment on an investment requires a number of judgments and estimates. The Company performs a quarterly analysis of the individual investments to determine if declines in market value are other-than-temporary. The analysis includes some or all of the following procedures as deemed appropriate by the Company:

- identifying all unrealized loss positions that have existed for at least six months;
- identifying other circumstances which management believes may impact the recoverability of the unrealized loss positions;
- obtaining a valuation analysis from third-party investment managers regarding the intrinsic value of these investments based on their knowledge and experience together with market-based valuation techniques;
- reviewing the trading range of certain investments over the preceding calendar period;
- assessing if declines in market value are other-than-temporary for debt instruments based on the investment grade credit ratings from third-party rating agencies;
- assessing if declines in market value are other-than-temporary for any debt instrument with a non-investment grade credit rating based on the continuity of its debt service record;
- determining the necessary provision for declines in market value that are considered other-than-temporary based on the analyses performed; and
- assessing the Company's ability and intent to hold these investments at least until the investment impairment is recovered.

The risks and uncertainties inherent in the assessment methodology used to determine declines in market value that are other-than-temporary include, but may not be limited to, the following:

- the opinions of professional investment managers could be incorrect;
- the past trading patterns of individual investments may not reflect future valuation trends;
- the credit ratings assigned by independent credit rating agencies may be incorrect due to unforeseen or unknown facts related to a company's financial situation; and
- the debt service pattern of non-investment grade instruments may not reflect future debt service capabilities and may not reflect a company's unknown underlying financial problems.

As a result of the analysis performed by the Company to determine declines in market value that are other-than-temporary, there were no write-downs for other-than-temporary impairments related to investments for the three months ended March 31, 2014 and March 31, 2013.



The Company has reviewed currently available information regarding investments with estimated fair values that are less than their carrying amounts and believes that these unrealized losses are not other-than-temporary and are primarily due to temporary

## KINGSWAY FINANCIAL SERVICES INC.

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market and sector-related factors rather than to issuer-specific factors. The Company does not intend to sell those investments, and it is not likely that it will be required to sell those investments before recovery of its amortized cost. The Company does not have any exposure to subprime mortgage-backed investments.

Limited liability investments include investments in limited liability companies and a limited partnership that primarily invest in income-producing real estate. The Company's interests in these investments are not deemed minor and, therefore, are accounted for under the equity method of accounting. As of March 31, 2014 and December 31, 2013, the carrying value of limited liability investments totaled \$4.7 million and \$4.4 million, respectively. At March 31, 2014, the Company has unfunded commitments totaling \$1.5 million to fund limited liability investments. Income from limited liability investments is recognized based on the Company's share of the earnings of the limited liability entities and is included in net investment income.

Other investments include collateral loans and are reported at their unpaid principal balance. As of March 31, 2014 and December 31, 2013, the carrying value of other investments totaled \$2.0 million and \$3.0 million, respectively. Gross realized gains and losses on fixed maturities, equity investments and limited liability investments for the three months ended March 31, 2014 and March 31, 2013 were as follows:

| (in thousands)        | Three months ended March 31, |       |
|-----------------------|------------------------------|-------|
|                       | 2014                         | 2013  |
| Gross realized gains  | \$48                         | \$309 |
| Gross realized losses | (9                           | ) —   |
| Total                 | \$39                         | \$309 |

Gross realized losses for the three months ended March 31, 2013 reported in the preceding table excludes the realized loss on sale of Atlas Financial Holdings Inc. ("Atlas") common stock recorded during the first quarter of 2013. Refer to Note 7, "Investment in Investee," for further discussion.

Net investment income for the three months ended March 31, 2014 and March 31, 2013, respectively, is comprised as follows:

| (in thousands)                            | Three months ended March 31, |       |
|---|------------------------------|-------|
|   | 2014                         | 2013  |
| Investment income                         |                              |       |
| Interest from fixed maturities            | \$272                        | \$282 |
| Dividends                                 | 32                           | 253   |
| Income from limited liability investments | 22                           | 50    |
| Other                                     | 142                          | 92    |
| Gross investment income                   | 468                          | 677   |
| Investment expenses                       | (55                          | ) (97 |
| Net investment income                     | \$413                        | \$580 |

At March 31, 2014, fixed maturities and short-term investments with an estimated fair value of \$13.4 million were on deposit with state and provincial regulatory authorities. Also, from time to time, the Company pledges investments to third-parties to collateralize liabilities incurred under its policies of insurance. At March 31, 2014, the amount of such pledged securities was \$17.4 million.

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

## NOTE 7 INVESTMENT IN INVESTEE

Investment in investee includes the Company's investment in the common stock of PIH. The carrying value, estimated fair value and approximate voting and equity percentages for the Company's investment in the common stock of PIH, which is accounted for under the equity method of accounting and reported as investment in investee in the Company's consolidated balance sheets at March 31, 2014, were as follows:

(in thousands, except for percentages)

|     | March 31, 2014    |                   |                      |                |
|-----|-------------------|-------------------|----------------------|----------------|
|     | Voting percentage | Equity percentage | Estimated Fair Value | Carrying value |
| PIH | 28.7              | % 28.7            | % \$8,000            | \$7,661        |

The fair value of the Company's investment in PIH at March 31, 2014 in the table above is calculated based on the initial public offering price of \$8.00 per share.

Investment in investee formerly included the Company's investment in the preferred and restricted voting common stock of Atlas. On February 12, 2013, the Company executed an underwriting agreement to sell 2,625,000 shares of Atlas common stock. The shares were being offered as part of Atlas' United States initial public offering at a price per share of \$5.85. During the first quarter of 2013, the Company received net proceeds of \$13.6 million and recognized a loss of \$1.7 million, which is included in net realized gains (losses) on the consolidated statements of operations, resulting from commissions and other expenses incurred as part of the sale. As a result of this sale, the Company's approximate voting percentage in Atlas was reduced to 16.5%. As a result of this change in ownership and other qualitative factors, the Company determined that its investment in the common stock of Atlas no longer qualified for the equity method of accounting. Prior to discontinuing the use of the equity method of accounting for Atlas, the Company used a reporting lag of three months to report its proportionate share of Atlas' results.

Equity in net income of investee was zero and \$0.3 million for the three months ended March 31, 2014 and March 31, 2013, respectively. The Company also recognized a decrease to shareholders' equity attributable to common shareholders of \$0.1 million for the three months ended March 31, 2013, for the Company's pro rata share of its investee's accumulated other comprehensive income.

During the fourth quarter of 2013, the Company further reduced its investment in the common stock of Atlas. The Company's investment in Atlas common stock at March 31, 2014 is included in equity investments and reported at fair value of \$1.8 million in the consolidated balance sheets.

## NOTE 8 DEFERRED ACQUISITION COSTS

Policy acquisition costs consist primarily of commissions, premium taxes, and underwriting and agency expenses, net of ceding commission income, incurred related to successful efforts to acquire new or renewal insurance contracts and vehicle service agreements. Acquisition costs deferred on both property and casualty insurance products and vehicle service agreements are amortized over the period in which the related revenues are earned.

The components of deferred acquisition costs and the related amortization expense for the three months ended March 31, 2014 and 2013, respectively, are comprised as follows:

| (in thousands)   | Three months ended March 31, |           |
|--|------------------------------|-----------|
|  | 2014                         | 2013      |
| Balance at January 1, net                                    | \$12,392                     | \$14,102  |
| Additions  | 7,274                        | 9,172     |
| Amortization   | (6,064                       | ) (10,589 |
| Acquisition costs disposed of during the year related to PIH | (1,043                       | ) —       |
| Balance at March 31, net                                     | \$12,559                     | \$12,685  |

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## NOTE 9 INTANGIBLE ASSETS

Intangible assets are comprised as follows:

(in thousands)

|   | March 31, 2014       |                          |                    |
|---|----------------------|--------------------------|--------------------|
|   | Gross Carrying Value | Accumulated Amortization | Net Carrying Value |
| Intangible assets subject to amortization     |                      |                          |                    |
| Database                                      | \$4,918              | \$676                    | \$4,242            |
| Vehicle service agreement in-force            | 3,680                | 2,409                    | 1,271              |
| Customer-related relationships                | 3,611                | 441                      | 3,170              |
| Non-compete agreement                         | 70                   | 33                       | 37                 |
| Intangible assets not subject to amortization |                      |                          |                    |
| Renewal rights                                | 46,756               | 15,438                   | 31,318             |
| Insurance licenses                            | 7,803                | —                        | 7,803              |
| Trade name                                    | 663                  | —                        | 663                |
| Total   | \$67,501             | \$18,997                 | \$48,504           |

(in thousands)

|   | December 31, 2013    |                          |                    |
|---|----------------------|--------------------------|--------------------|
|   | Gross Carrying Value | Accumulated Amortization | Net Carrying Value |
| Intangible assets subject to amortization     |                      |                          |                    |
| Database                                      | \$4,918              | \$554                    | \$4,364            |
| Vehicle service agreement in-force            | 3,680                | 2,220                    | 1,460              |
| Customer-related relationships                | 3,611                | 344                      | 3,267              |
| Non-compete agreement                         | 70                   | 27                       | 43                 |
| Intangible assets not subject to amortization |                      |                          |                    |
| Renewal rights                                | 46,756               | 15,438                   | 31,318             |
| Insurance licenses                            | 7,803                | —                        | 7,803              |
| Trade name                                    | 663                  | —                        | 663                |
| Total   | \$67,501             | \$18,583                 | \$48,918           |

The Company's intangible assets with definite useful lives are amortized over their estimated useful lives.

Amortization of intangible assets was \$0.4 million and \$0.6 million for the three months ended March 31, 2014 and March 31, 2013, respectively.

The insurance licenses, renewal rights and trade name intangible assets have indefinite useful lives and are not amortized. The renewal rights intangible assets, recognized related to the acquisitions of Northeast Alliance Insurance Agency, LLC ("NEA") and Assigned Risk Solutions Ltd. ("ARS"), were originally being amortized on a straight-line basis over 10 to 15 years. As a result of the acquisition of ARS during 2010, the Company determined that it was necessary to re-examine the useful lives assigned to the renewal rights intangible assets due to the fact that NEA and ARS service the assigned risk business in the states of New York and New Jersey and operate in the New York voluntary markets where there is limited competition for the renewal rights. As a result of the review performed, the Company determined that there were no legal, regulatory, contractual, competitive, economic, or other factors limiting the useful life of the renewal rights intangible assets; therefore, effective January 1, 2011, the renewal rights intangible assets were deemed to have indefinite useful lives and are no longer being amortized. The renewal rights had accumulated amortization of \$15.4 million at December 31, 2010.

## NOTE 10 ASSET HELD FOR SALE

As of March 31, 2014, property consisting of building and land located in Miami, Florida with a carrying value of \$6.3 million was classified as held for sale. At March 31, 2014, the carrying value of the property is equal to its fair value net of estimated selling costs.



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## NOTE 11 UNPAID LOSS AND LOSS ADJUSTMENT EXPENSES

The establishment of the provision for unpaid loss and loss adjustment expenses is based on known facts and interpretation of circumstances and is therefore a complex and dynamic process influenced by a large variety of factors. These factors include the Company's experience with similar cases and historical trends involving loss payment patterns, pending levels of unpaid loss and loss adjustment expenses, product mix or concentration, loss severity and loss frequency patterns.

Other factors include the continually evolving and changing regulatory and legal environment; actuarial studies; professional experience and expertise of the Company's claims departments' personnel and independent adjusters retained to handle individual claims; the quality of the data used for projection purposes; existing claims management practices including claims-handling and settlement practices; the effect of inflationary trends on future loss settlement costs; court decisions; economic conditions; and public attitudes.

Consequently, the process of determining the provision necessarily involves risks that the actual results will deviate, perhaps materially, from the best estimates made.

The Company's evaluation of the adequacy of unpaid loss and loss adjustment expenses includes a re-estimation of the liability for unpaid loss and loss adjustment expenses relating to each preceding financial year compared to the liability that was previously established.

## (a) Property and Casualty

The results of this comparison and the changes in the provision for property and casualty unpaid loss and loss adjustment expenses, net of amounts recoverable from reinsurers, as of March 31, 2014 and March 31, 2013 were as follows:

| (in thousands)   | March 31, 2014 | March 31, 2013 |
|--|----------------|----------------|
| Balance at beginning of period, gross  | \$84,534       | \$103,116      |
| Less reinsurance recoverable related to property and casualty unpaid loss and loss adjustment expenses | 7,942          | 5,478          |
| Balance at beginning of period, net  | 76,592         | 97,638         |
| Incurred related to:   |                |                |
| Current year   | 19,887         | 20,950         |
| Prior years  | (586)          | (789)          |
| Paid related to:   |                |                |
| Current year   | (6,268)        | (8,210)        |
| Prior years  | (17,727)       | (19,685)       |
| Disposal of unpaid loss and loss adjustment expenses related to PIH                                    | (405)          | —              |
| Balance at end of period, net  | 71,493         | 89,904         |
| Plus reinsurance recoverable related to property and casualty unpaid loss and loss adjustment expenses | 5,792          | 8,019          |
| Balance at end of period, gross  | \$77,285       | \$97,923       |

## KINGSWAY FINANCIAL SERVICES INC.

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## (b) Vehicle Service Agreements

The results of the comparison and the changes in the provision for vehicle service agreement unpaid loss and loss adjustment expenses as of March 31, 2014 and March 31, 2013 were as follows:

| (in thousands)                 | March 31, 2014 | March 31, 2013 |
|--------------------------------|----------------|----------------|
| Balance at beginning of period | \$3,128        | \$3,448        |
| Incurring related to:          |                |                |
| Current year                   | 1,760          | 1,670          |
| Prior years                    | —              | —              |
| Paid related to:               |                |                |
| Current year                   | (1,699)        | (1,756)        |
| Prior years                    | (61)           | (81)           |
| Balance at end of period       | \$3,128        | \$3,281        |

## NOTE 12 DEBT

Debt consists of the following instruments:

| (in thousands)                | March 31, 2014 |            | December 31, 2013 |            |
|-------------------------------|----------------|------------|-------------------|------------|
|                               | Principal      | Fair Value | Principal         | Fair Value |
| 7.5% senior notes due 2014    | \$—            | \$—        | \$14,356          | \$14,356   |
| LROC preferred units due 2015 | 14,291         | 14,291     | 14,854            | 14,854     |
| Subordinated debt             | 90,500         | 28,471     | 90,500            | 28,471     |
| Total                         | \$104,791      | \$42,762   | \$119,710         | \$57,681   |

Subordinated indebtedness mentioned above consists of the following trust preferred debt instruments:

| Issuer                          | Principal | Issue date | Interest  | Redemption date |
|---------------------------------|-----------|------------|---|-----------------|
| Kingsway CT Statutory Trust I   | 15,000    | 12/4/2002  | annual interest rate equal to LIBOR, plus 4.00% payable quarterly | 12/4/2032       |
| Kingsway CT Statutory Trust II  | 17,500    | 5/15/2003  | annual interest rate equal to LIBOR, plus 4.10% payable quarterly | 5/15/2033       |
| Kingsway CT Statutory Trust III | 20,000    | 10/29/2003 | annual interest rate equal to LIBOR, plus 3.95% payable quarterly | 10/29/2033      |
| Kingsway DE Statutory Trust III | 15,000    | 5/23/2003  | annual interest rate equal to LIBOR, plus 4.20% payable quarterly | 5/23/2033       |
| Kingsway DE Statutory Trust IV  | 10,000    | 9/30/2003  | annual interest rate equal to LIBOR, plus 3.85% payable quarterly | 9/30/2033       |
| Kingsway DE Statutory Trust VI  | 13,000    | 1/8/2004   | annual interest rate equal to LIBOR, plus 4.00% payable quarterly | 1/8/2034        |

During the first quarter of 2011, the Company gave notice to its Trust Preferred trustees of its intention to exercise its voluntary right to defer interest payments for up to 20 quarters, pursuant to the contractual terms of its outstanding Trust Preferred indentures, which permit interest deferral. This action does not constitute a default under the Company's Trust Preferred indentures or any of its other debt indentures. At March 31, 2014, deferred interest payable of \$13.9 million is included in accrued expenses and other liabilities in the consolidated balance sheets. During the first quarter of 2014, the Company repaid the \$14.4 million remaining amount outstanding on its senior unsecured debentures due February 1, 2014. During the three months ended March 31, 2013, the Company purchased for \$0.6 million, including accrued interest, \$0.6 million of par value of its senior unsecured debentures due February 1, 2014 with a carrying value of \$0.6 million, including accrued interest, recording a loss of \$0.0 million.





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## NOTE 13 INCOME TAXES

Income tax expense (benefit) for the three months ended March 31, 2014 varies from the amount that would result by applying the applicable United States income tax rate of 34% to loss before income tax expense (benefit) primarily due to a valuation allowance being applied to the Company's operating losses, a tax expense being recorded attributable to the Company's indefinite life intangible assets, a tax benefit being recorded for a Canadian income tax refund, a tax benefit being recorded for non-taxable dividend income, a state income tax expense being recorded, a tax expense being recorded for a loss on the disposal of a subsidiary and a tax expense being recorded for stock option expense. Income tax expense (benefit) for the three months ended March 31, 2013 varies from the amount that would result by applying the applicable United States income tax rate of 34% to loss before income tax expense (benefit) primarily due to a valuation allowance being applied to the Company's operating losses, a tax expense being recorded attributable to the Company's indefinite life intangible assets and a tax benefit being recorded for non-taxable dividend income.

The Company maintains a valuation allowance for its gross deferred tax assets at March 31, 2014 and December 31, 2013. The Company's operations have generated substantial operating losses during the last several years. These losses can be available to reduce income taxes that might otherwise be incurred on future taxable income. The Company's operations, however, remain challenged and, as a result, it is uncertain whether the Company will generate the taxable income necessary to utilize these losses or other reversing temporary differences. This uncertainty has caused management to place a full valuation allowance on its March 31, 2014 and December 31, 2013 net deferred tax asset. The Company carries a deferred income tax liability of \$4.5 million and \$4.2 million at March 31, 2014 and December 31, 2013, respectively, all of which relates to indefinite life intangible assets.

As of March 31, 2014 and December 31, 2013, the Company carried a liability for unrecognized tax benefits of \$1.5 million and \$3.2 million, respectively, that is included in income taxes payable in the consolidated balance sheets. The Company generally recognizes interest and penalties related to unrecognized tax benefits in income tax expense (benefit).

## NOTE 14 NET LOSS PER SHARE

The following table sets forth the reconciliation of numerators and denominators for the basic and diluted loss per share computation for the three months ended March 31, 2014 and March 31, 2013:

| (in thousands)  | Three months ended March 31, |             |
|---|------------------------------|-------------|
|   | 2014                         | 2013        |
| Numerator:  |                              |             |
| Net loss  | \$(1,006 )                   | \$(17,336 ) |
| Less: net income attributable to noncontrolling interests | (653 )                       | (95 )       |
| Less: dividends on preferred stock                        | (53 )                        | —           |
| Net loss attributable to common shareholders              | (1,712 )                     | (17,431 )   |
| Denominator:  |                              |             |
| Weighted average basic shares                             |                              |             |
| Weighted average common shares outstanding                | 16,430                       | 13,149      |
| Weighted average diluted shares                           |                              |             |
| Weighted average common shares outstanding                | 16,430                       | 13,149      |
| Effect of potentially dilutive securities                 | —                            | —           |
| Total weighted average diluted shares                     | 16,430                       | 13,149      |
| Basic loss per common share                               | \$(0.10 )                    | \$(1.33 )   |
| Diluted loss per common share                             | \$(0.10 )                    | \$(1.33 )   |

Net loss per share is based on the weighted-average number of shares outstanding. Diluted weighted-average shares is calculated by adjusting basic weighted-average shares outstanding by all potentially dilutive securities. Potentially dilutive securities consist of stock options, unvested restricted stock awards, warrants and convertible preferred stock. Since the Company is reporting a net loss for the three months ended March 31, 2014 and March 31, 2013, all potentially dilutive securities outstanding were excluded from the calculation of both basic and diluted loss per share

since their inclusion would have been anti-dilutive.

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## NOTE 15 STOCK-BASED COMPENSATION

## (a) Stock Options

The following table summarizes the stock option activity during the three months ended March 31, 2014: (in thousands, except for share data)

|                                  | Number of<br>Options<br>Outstanding | Weighted-Average<br>Exercise Price | Weighted-Average<br>Remaining<br>Contractual Term<br>(in Years) | Aggregate<br>Intrinsic Value |
|----------------------------------|-------------------------------------|------------------------------------|---|------------------------------|
| Outstanding at December 31, 2013 | 355,625                             | C\$ 18.35                          |   | —                            |
| Granted                          | 611,875                             | \$ 4.50                            |   |                              |
| Exchanged and Cancelled          | (351,875 )                          | C\$ 18.12                          |   |                              |
| Expired                          | (1,875 )                            | C\$ 40.12                          |   |                              |
| Forfeited                        | (1,875 )                            | C\$ 40.12                          |   |                              |
| Outstanding at March 31, 2014    | 611,875                             | \$ 4.50                            | 4.0   | —                            |
| Exercisable at March 31, 2014    | 611,875                             | \$ 4.50                            | 4.0   | —                            |

The intrinsic value of a stock option grant is the difference between the March 31, 2014 market price for the Company's common shares and the exercise price of the option. The aggregate intrinsic value for the stock options outstanding at March 31, 2014 was zero. The aggregate intrinsic value for stock options exercisable at March 31, 2014 was zero.

The Company uses the Black-Scholes option pricing model to estimate the fair value of each option on the date of grant. The assumptions used in the Black-Scholes pricing model for options granted or exchanged during the three months ended March 31, 2014 were as follows:

|                          |                |   |
|--------------------------|----------------|---|
| Risk-free interest rate  | March 31, 2014 |   |
| Dividend yield           | 0.06% - 1.4%   |   |
| Expected volatility      | —              |   |
| Expected term (in years) | 0.4            | % |
|                          | 0.78 - 4       |   |

## (b) Restricted Stock Awards

Under the 2013 Equity Incentive Plan, the Company made grants of restricted stock to certain officers of the Company. The restricted stock vests after a ten-year period and is subject to the officer's continued employment through the vesting date. The restricted stock is amortized on a straight-line basis over the ten-year requisite service period. Total unamortized compensation expense related to unvested awards at March 31, 2014 was \$8.2 million. The grant-date fair value of restricted stock awards is determined using the closing price of Kingsway common stock on the date of grant. The following table summarizes the activity related to unvested restricted stock for the three months ended March 31, 2014:

(in thousands, except for share data)

|                               | Restricted stock<br>awards | Weighted-average<br>grant date fair value<br>(per share) |
|-------------------------------|----------------------------|--|
| Unvested at December 31, 2013 | —                          | —  |
| Granted                       | \$1,972,345                | \$4.14   |
| Unvested at March 31, 2014    | \$1,972,345                | \$4.14   |

Total stock-based compensation expense, net of forfeitures was \$0.6 million and \$0.0 million for the three months ended March 31, 2014 and March 31, 2013, respectively.

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## NOTE 16 SHAREHOLDERS' EQUITY

On May 13, 2013, the Company's shareholders approved an amendment to the Company's Articles of Incorporation to create an unlimited number of zero par value class A preferred shares. The Company's Board of Directors will have the ability to fix the designation, rights, privileges, restrictions and conditions attaching to the shares of each series of preferred shares. The preferred shares will have priority over the common shares.

On February 3, 2014, the Company closed on its previously announced private placement totaling \$6.6 million. At closing, the Company received gross proceeds of \$6.6 million, resulting from the sale and issuance of 262,876 units for a purchase price of \$25.00 per unit. Net proceeds to the Company were \$6.4 million after deducting expenses. Each unit consists of one class A convertible preferred share, series 1 (the "Preferred Shares"), and 6.25 common share class C purchase warrants. Each Preferred Share is convertible into 6.25 common shares at a conversion price of \$4.00 per common share any time at the option of the holder prior to April 1, 2021. The maximum number of common shares issuable upon conversion of the Preferred Shares is 1,642,975 common shares. Each warrant will entitle the subscriber to purchase one common share of Kingsway at a price of \$5.00 per common share at any time after September 16, 2016 and prior to expiry on September 15, 2023.

The Preferred Shares are not entitled to vote. The holders of the Preferred Shares are entitled to receive fixed, cumulative, preferential cash dividends at a rate of \$1.25 per Preferred Share per year. The cash dividend rate shall be revised to \$1.875 per Preferred Share per year if the dividend accumulates for a period greater than 30 consecutive months from the date of the most recent dividend payment. On and after February 3, 2016, the Company may redeem all or any part of the then outstanding Preferred Shares for the price of \$28.75 per Preferred Share, plus accrued but unpaid dividends thereon, whether or not declared, up to and including the date specified for redemption. The Company will redeem all outstanding Preferred Shares on April 1, 2021 for the price of \$25.00 per Preferred Share, plus accrued but unpaid dividends, whether or not declared, up to and including the date specified for redemption.

## NOTE 17 ACCUMULATED OTHER COMPREHENSIVE INCOME

The table below details the change in the balance of each component of accumulated other comprehensive income, net of tax, for the three months ended March 31, 2014 and March 31, 2013 as relates to shareholders' equity attributable to common shareholders on the unaudited consolidated balance sheets. On the other hand, the unaudited consolidated statements of comprehensive income (loss) present the components of other comprehensive income (loss), net of tax, only for the three months ended March 31, 2014 and March 31, 2013 and inclusive of the components attributable to noncontrolling interests in consolidated subsidiaries.

(in thousands)

|   | Unrealized Gains<br>(Losses) on Fixed<br>Maturities and<br>Equity<br>Investments | Foreign<br>Currency<br>Translation<br>Adjustments | Equity in Other<br>Comprehensive<br>Loss of Investee | Total<br>Accumulated<br>Other<br>Comprehensive<br>Income |
|---|--|---|--|--|
| Balance, January 1, 2014  | 15,583   | (5,982  | ) —  | 9,601  |
| Other comprehensive income before<br>reclassifications              | 1,276  | 44  | —  | 1,320  |
| Amounts reclassified from accumulated<br>other comprehensive income | 52   | —   | —  | 52   |
| Net current-period other comprehensive<br>income                    | 1,328  | 44  | —  | 1,372  |
| Balance, March 31, 2014   | 16,911   | (5,938  | ) —  | 10,973   |



## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

(in thousands)

|   | Unrealized Gains<br>(Losses) on Fixed<br>Maturities and<br>Equity<br>Investments | Foreign<br>Currency<br>Translation<br>Adjustments | Equity in Other<br>Comprehensive<br>Loss of Investee | Total<br>Accumulated<br>Other<br>Comprehensive<br>Income |   |
|---|--|---|--|--|---|
| Balance, January 1, 2013  | 14,194   | 1,210   | (642   | ) 14,762   |   |
| Other comprehensive (loss) income before<br>reclassifications       | (498   | ) 26  | (105   | ) (577   | ) |
| Amounts reclassified from accumulated<br>other comprehensive income | 248  | —   | —  | 248  |   |
| Net current-period other comprehensive<br>(loss) income             | (250   | ) 26  | (105   | ) (329   | ) |
| Balance, March 31, 2013   | 13,944   | 1,236   | (747   | ) 14,433   |   |

Components of accumulated other comprehensive income were reclassified to the following lines of the unaudited consolidated statements of operations for the three months ended March 31, 2014 and March 31, 2013:

|   | Three months ended March 31,<br>2014 | Three months ended March 31,<br>2013 |   |
|---|--------------------------------------|--------------------------------------|---|
| Reclassification of accumulated other comprehensive income from unrealized<br>(losses) gains on fixed maturities and equity investments to: |                                      |                                      |   |
| Net realized gains (losses)   | \$(52                                | ) \$(248                             | ) |
| Other-than-temporary impairment loss  | —                                    | —                                    |   |
| Loss before income tax expense (benefit)  | (52                                  | ) (248                               | ) |
| Income tax expense (benefit)  | —                                    | —                                    |   |
| Net loss  | \$(52                                | ) \$(248                             | ) |

## NOTE 18 SEGMENTED INFORMATION

The Company operates as a merchant bank primarily engaged, through its subsidiaries, in the property and casualty insurance business. The Company conducts its business through the following two reportable segments: Insurance Underwriting and Insurance Services.

## Insurance Underwriting Segment

Effective March 31, 2014, the Company's wholly owned subsidiary, PIH, completed an initial public offering of its common stock. Upon completion of the transaction, the Company maintained a 28.7% interest in the common shares of PIH, which is reported as investment in investee in the consolidated balance sheets. The earnings of PIH are included in the consolidated statements of operations through the March 31, 2014 transaction date. Prior to the transaction, PIH was included in the Insurance Underwriting segment. As a result of the disposal of the Company's majority interest in PIH on March 31, 2014, all segmented information has been restated to exclude PIH from the Insurance Underwriting segment.

Insurance Underwriting includes the following subsidiaries of the Company: Mendota Insurance Company, Mendakota Insurance Company, Universal Casualty Company ("UCC"), Kingsway Amigo Insurance Company ("Amigo") and Kingsway Reinsurance Corporation (collectively, "Insurance Underwriting"). In September 2013, Kingsway Reinsurance (Bermuda) Ltd., formerly included in Insurance Underwriting, was liquidated. Insurance Underwriting principally offers personal automobile insurance to drivers who do not meet the criteria for coverage by standard automobile insurers and actively conducts business in 15 states.



## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

The Company previously placed Amigo and UCC into voluntary run-off in 2012 and 2011, respectively. Each of Amigo and UCC has entered into a comprehensive run-off plan which has been approved by its respective state of domicile. Kingsway continues to manage Amigo and UCC in a manner consistent with the run-off plans.

## Insurance Services Segment

Insurance Services includes the following subsidiaries of the Company: ARS, IWS Acquisition Corporation ("IWS") and Trinity (collectively, "Insurance Services").

ARS is a licensed property and casualty agent, full service managing general agent and third-party administrator focused primarily on the assigned risk market. ARS is licensed to administer business in 22 states but generates its revenues primarily by operating in the states of New York and New Jersey.

IWS is a licensed motor vehicle service agreement company and is a provider of after-market vehicle protection services distributed by credit unions in 26 states to their members.

Trinity is a provider of warranty products and maintenance support to consumers and businesses in the HVAC and refrigeration industry. Trinity distributes its warranty products through original equipment manufacturers, HVAC distributors and commercial and residential contractors. Trinity distributes its maintenance support directly through corporate owners of retail spaces throughout the United States.

Results for the Company's reportable segments are based on the Company's internal financial reporting systems and are consistent with those followed in the preparation of the unaudited consolidated interim financial statements. The following tables provide financial data used by management. Segment assets are not allocated for management use and, therefore, are not included in the segment disclosures below.

Revenue by reportable segment reconciled to consolidated revenues for the three months ended March 31, 2014 and 2013 were:

| (in thousands)                                | Three months ended March 31, |          |
|---|------------------------------|----------|
|   | 2014                         | 2013     |
| Revenues:                                     |                              |          |
| Insurance Underwriting:                       |                              |          |
| Net premiums earned                           | \$27,806                     | \$27,153 |
| Other income                                  | 2,134                        | 2,291    |
| Total Insurance Underwriting                  | 29,940                       | 29,444   |
| Insurance Services:                           |                              |          |
| Service fee and commission income             | 14,724                       | 13,124   |
| Other income                                  | 99                           | 86       |
| Total Insurance Services                      | 14,823                       | 13,210   |
| Total segment revenues                        | 44,763                       | 42,654   |
| Net premiums earned not allocated to segments | 4,114                        | 915      |
| Net investment income                         | 413                          | 580      |
| Net realized gains (losses)                   | 39                           | (1,409)  |
| Other income not allocated to segments        | (162)                        | (159)    |
| Total revenues                                | \$49,167                     | \$42,581 |

The operating income (loss) of each segment in the following table is before income taxes and includes revenues and direct segment costs.



## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

Segment operating income (loss) reconciled to the consolidated net loss for the three months ended March 31, 2014 and 2013 were:

| (in thousands)   | Three months ended March 31, |            |
|--|------------------------------|------------|
|  | 2014                         | 2013       |
| Segment operating income (loss)                          |                              |            |
| Insurance Underwriting                                   | \$257                        | \$(3,045)  |
| Insurance Services                                       | 1,914                        | 1,916      |
| Total segment operating income (loss)                    | 2,171                        | (1,129)    |
| Net investment income                                    | 413                          | 580        |
| Net realized gains (losses)                              | 39                           | (1,409)    |
| Other income and expenses not allocated to segments, net | (470)                        | (4,388)    |
| Interest expense   | (1,433)                      | (1,833)    |
| Amortization of intangible assets                        | (414)                        | (558)      |
| Contingent consideration expense                         | (267)                        | (155)      |
| Gain (loss) on change in fair value of debt              | 563                          | (8,951)    |
| Loss on disposal of subsidiary                           | (1,242)                      | —          |
| Loss on buy-back of debt                                 | —                            | (24)       |
| Equity in net income of investee                         | —                            | 255        |
| Loss before income tax expense (benefit)                 | \$(640)                      | \$(17,612) |
| Income tax expense (benefit)                             | 366                          | (276)      |
| Net loss   | \$(1,006)                    | \$(17,336) |

Net premiums earned by line of business for the three months ended March 31, 2014 and 2013 were:

| (in thousands)                                 | Three months ended March 31, |          |
|--|------------------------------|----------|
|  | 2014                         | 2013     |
| Insurance Underwriting:                        |                              |          |
| Private passenger auto liability               | \$18,556                     | \$18,661 |
| Auto physical damage                           | 9,250                        | 7,843    |
| Total non-standard automobile                  | 27,806                       | 26,504   |
| Commercial auto liability                      | —                            | 649      |
| Total Insurance Underwriting                   | 27,806                       | 27,153   |
| Net premiums earned not allocated to segments: |                              |          |
| Allied lines                                   | 1,944                        | —        |
| Homeowners                                     | 2,159                        | 915      |
| Other  | 11                           | —        |
| Total net premiums not allocated to segments   | \$4,114                      | \$915    |
| Total net premiums earned                      | \$31,920                     | \$28,068 |

## NOTE 19 RESTRUCTURING

On September 17, 2012, the Company announced that it was restructuring its Insurance Underwriting and Insurance Services segments. As part of the restructuring, the Company intends to streamline its non-standard property and casualty insurance business operations. Specific to Insurance Underwriting, during the fourth quarter of 2012, the Company began taking steps to place all of Amigo into voluntary run-off. Amigo has entered into a comprehensive run-off plan which has been approved by the Florida Office of Insurance Regulation. Kingsway continues to manage Amigo in a manner consistent with its filed run-off plan.

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

As part of the restructuring, the Company will reduce staffing levels to be consistent with placing Amigo into run-off. The Company estimated that Insurance Underwriting would incur approximately \$2.0 million in cash severance expenses due to reductions-in-force as part of the restructuring during the period beginning with the announcement through the end of 2013. From the time the restructuring was announced on September 17, 2012 through March 31, 2014, the Company has incurred severance expense of \$2.1 million, \$2.0 million of which has been paid through March 31, 2014.

Changes in the restructuring liability, which is included in accrued expenses and other liabilities in the consolidated balance sheets, and the related restructuring expense for the three months ended March 31, 2014 and March 31, 2013 is as follows:

| (in thousands)                              | March 31, 2014                               |                       |               |  |
|---|--|-----------------------|---------------|--|
|   | Restructuring liability, beginning of period | Restructuring expense | Cash payments | Restructuring liability, end of period |
| Insurance Underwriting:                     |  |                       |               |  |
| Severance                                   | 236  | —                     | (127)         | ) 109                                  |
| Lease abandonment                           | 648  | 16                    | (92)          | ) 572                                  |
| Total Insurance Underwriting                | 884  | 16                    | (219)         | ) 681                                  |
| Insurance Services:                         |  |                       |               |  |
| Lease abandonment                           | 100  | 4                     | (15)          | ) 89                                   |
| Total Insurance Services                    | 100  | 4                     | (15)          | ) 89                                   |
| Severance expense not allocated to segments | 146  | —                     | (146)         | ) —                                    |
| Total                                       | 1,130  | 20                    | (380)         | ) 770                                  |
| (in thousands)                              | March 31, 2013                               |                       |               |  |
|   | Restructuring liability, beginning of period | Restructuring expense | Cash payments | Restructuring liability, end of period |
| Insurance Underwriting:                     |  |                       |               |  |
| Severance                                   | 214  | 759                   | (487)         | ) 486                                  |
| Lease abandonment                           | 1,207  | 21                    | (89)          | ) 1,139                                |
| Total                                       | 1,421  | 780                   | (576)         | ) 1,625                                |

## NOTE 20 FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value amounts represent estimates of the consideration that would currently be agreed upon between knowledgeable, willing parties who are under no compulsion to act. Fair value is best evidenced by quoted bid or ask price, as appropriate, in an active market. Where bid or ask prices are not available, such as in an illiquid or inactive market, the closing price of the most recent transaction of that instrument subject to appropriate adjustments as required is used. Where quoted market prices are not available, the quoted prices of similar financial instruments or valuation models with observable market-based inputs are used to estimate the fair value. These valuation models may use multiple observable market inputs, including observable interest rates, foreign exchange rates, index levels, credit spreads, equity prices, counterparty credit quality, corresponding market volatility levels and option volatilities. Minimal management judgment is required for fair values calculated using quoted market prices or observable market inputs for models. Greater subjectivity is required when making valuation adjustments for financial instruments in

inactive markets or when using models where observable parameters do not exist. Also, the calculation of estimated fair value is based on market conditions at a specific point in time and may not be reflective of future fair values. For the Company's financial instruments carried at cost or amortized cost, the book value is not adjusted to reflect increases or decreases in fair value due to market fluctuations, including those due to interest rate changes, as it is the Company's intention to hold them until there is a recovery of fair value, which may be to maturity.

The Company classifies its investments in fixed maturities and equity investments as available-for-sale and reports these investments at fair value. The Company's LROC preferred units, senior unsecured debentures, subordinated debt and contingent consideration liabilities are measured and reported at fair value.

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

Fixed maturities and equity investments - Fair values of fixed maturities for which no active market exists are derived from quoted market prices of similar instruments or other third-party evidence. Fair values of equity investments are considered to approximate quoted market values based on the latest bid prices in active markets.

Debt - The fair value of the LROC preferred units is based on quoted market prices, and the fair value of the subordinated debt is estimated using an internal model based on significant market observable inputs. The fair value of senior unsecured debentures, for which no active market exists, was derived from quoted market prices of similar instruments or other third-party evidence.

Contingent consideration - The consideration for certain of the Company's acquisitions includes future payments to the former owners that are contingent upon the achievement of certain targets over future reporting periods. Liabilities for contingent consideration are measured and reported at fair value and are included in accrued expenses and other liabilities in the consolidated balance sheets. The fair value of contingent consideration liabilities is estimated using internal models without relevant observable market inputs. Estimated payments are discounted using present value techniques to arrive at estimated fair value. Changes in the fair value of contingent consideration liabilities can result from changes to one or multiple inputs, including adjustments to the discount rates or changes in the assumed achievement or timing of any targets. Changes in assumptions could have an impact on the payout of contingent consideration liabilities. Changes in fair value are reported in the consolidated statements of operations as contingent consideration expense. The maximum the Company can pay in future contingent payments is \$13.5 million, on an undiscounted basis.

The Company employs a fair value hierarchy to categorize the inputs it uses in valuation techniques to measure the fair value. The extent of use of quoted market prices (Level 1), valuation models using observable market information (Level 2) and internal models without observable market information (Level 3) in the valuation of the Company's financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2014 and December 31, 2013 was as follows:

(in thousands)

|   | Total    | March 31, 2014  |   |  |
|---|----------|---|---|--|
|   |          | Fair Value Measurements at the End of the Reporting Period Using              |   |  |
|   |          | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets (Level<br>1) | Significant<br>Other<br>Observable<br>Inputs (Level<br>2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
| Recurring fair value measurements                               |          |   |   |  |
| Assets:   |          |   |   |  |
| Fixed maturities:   |          |   |   |  |
| U.S. government, government agencies and authorities            | \$15,765 | \$—   | \$15,765  | \$—  |
| Canadian government   | 4,256    | —   | 4,256   | —  |
| States municipalities and political subdivisions                | 6,256    | —   | 6,256   | —  |
| Mortgage-backed   | 1,967    | —   | 1,967   | —  |
| Asset-backed securities and collateralized mortgage obligations | 4,491    | —   | 4,491   | —  |
| Corporate   | 18,721   | —   | 18,721  | —  |
| Total fixed maturities  | 51,456   | —   | 51,456  | —  |
| Equity investments  | 9,982    | 9,982   | —   | —  |
| Other investments   | 2,000    | —   | 2,000   | —  |

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|                          |          |          |          |         |
|--------------------------|----------|----------|----------|---------|
| Short-term investments   | 401      | —        | 401      | —       |
| Total assets             | \$63,839 | \$9,982  | \$53,857 | \$—     |
| Liabilities:             |          |          |          |         |
| LROC preferred units     | 14,291   | 14,291   | —        | —       |
| Subordinated debt        | 28,471   | —        | 28,471   | —       |
| Contingent consideration | \$5,611  | \$—      | \$—      | \$5,611 |
| Total liabilities        | \$48,373 | \$14,291 | \$28,471 | \$5,611 |

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

(in thousands)

|  | Total    | December 31, 2013<br>Fair Value Measurements at the End of the<br>Reporting Period Using |   |  |
|--|----------|--|---|--|
|  |          | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets (Level<br>1)            | Significant<br>Other<br>Observable<br>Inputs (Level<br>2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
| Recurring fair value measurements                                  |          |  |   |  |
| Assets:  |          |  |   |  |
| Fixed maturities:  |          |  |   |  |
| U.S. government, government agencies and<br>authorities            | \$18,338 | \$—  | \$18,338  | \$—  |
| Canadian government  | 4,082    | —  | 4,082   | —  |
| States municipalities and political subdivisions                   | 6,231    | —  | 6,231   | —  |
| Mortgage-backed  | 2,006    | —  | 2,006   | —  |
| Asset-backed securities and collateralized<br>mortgage obligations | 3,994    | —  | 3,994   | —  |
| Corporate  | 19,500   | —  | 19,500  | —  |
| Total fixed maturities   | 54,151   | —  | 54,151  | —  |
| Equity investments   | 7,137    | 7,137  | —   | —  |
| Other investments  | 3,000    | —  | 3,000   | —  |
| Short-term investments   | 501      | —  | 501   | —  |
| Total assets   | \$64,789 | \$7,137  | \$57,652  | \$—  |
| Liabilities:   |          |  |   |  |
| LROC preferred units   | 14,854   | 14,854   | —   | —  |
| Senior unsecured debentures  | 14,356   | —  | 14,356  | —  |
| Subordinated debt  | 28,471   | —  | 28,471  | —  |
| Contingent consideration   | 5,344    | —  | —   | 5,344  |
| Total liabilities  | \$63,025 | \$14,854   | \$42,827  | \$5,344  |

The following table provides a reconciliation of the fair value of recurring Level 3 fair value measurements for the three months ended March 31, 2014 and March 31, 2013:

(in thousands)

|   | Three months ended March 31, |       |
|---|------------------------------|-------|
|   | 2014                         | 2013  |
| Contingent consideration:   |                              |       |
| Beginning balance   | 5,344                        | 3,987 |
| Change in fair value of contingent consideration included in net loss | 267                          | 155   |
| Ending balance  | 5,611                        | 4,142 |



KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) March 31, 2014

NOTE 21 RELATED PARTY TRANSACTIONS

Related party transactions, including services provided to or received by the Company's subsidiaries, are carried out in the normal course of operations and are measured in part by the amount of consideration paid or received as established and agreed by the parties. Management believes that consideration paid for such services in each case approximates fair value. Except where disclosed elsewhere in these unaudited consolidated interim financial statements, the following is a summary of related party transactions.

On February 11, 2014, the Company's subsidiary, 1347 Advisors LLC ("1347 Advisors") entered into a Management Services Agreement ("MSA") with PIH which provides for certain services, including forecasting, analysis of capital structure and reinsurance programs, consultation in future restructuring or capital raising transactions, and consultation in corporate development initiatives, that 1347 Advisors will provide to PIH unless and until 1347 Advisors and PIH agree to terminate the services.

On March 7, 2014, the Company's subsidiary, 1347 Capital LLC ("1347 Capital") appointed Gordon G. Pratt, CEO of Fund Management Group ("FMG"), as Chairman of 1347 Capital. At March 31, 2014, the Company has a note receivable of \$1.5 million outstanding from FMG.

On March 26, 2014, the Company entered into a Performance Share Grant Agreement with PIH, whereby the Company will be entitled to receive up to an aggregate of 375,000 shares of PIH common stock upon achievement of certain milestones for PIH's stock price. Pursuant to the terms of the Performance Share Grant Agreement, if at any time the last sales price of PIH's common stock equals or exceeds: (i) \$12.00 per share (as adjusted for stock splits, stock dividends, reorganizations, recapitalizations and the like) for any 20 trading days within any 30-trading day period, the Company will receive 125,000 shares of PIH common stock; (ii) \$15.00 per share (as adjusted for stock splits, stock dividends, reorganizations, recapitalizations and the like) for any 20 trading days within any 30-trading day period, the Company will receive 125,000 shares of PIH common stock (in addition to the 125,000 shares of common stock earned pursuant to clause (i) herein); and (iii) \$18.00 per share (as adjusted for stock splits, stock dividends, reorganizations, recapitalizations and the like) for any 20 trading days within any 30-trading day period, the Company will receive 125,000 shares of PIH common stock (in addition to the 250,000 shares of common stock earned pursuant to clauses (i) and (ii) herein). The shares of common stock granted to the Company will have a valuation equal to the last sales price of PIH common stock on the day prior to such grant.

NOTE 22 COMMITMENTS AND CONTINGENCIES

(a) Legal proceedings:

In connection with its operations in the ordinary course of business, the Company and its subsidiaries are named as defendants in various actions for damages and costs allegedly sustained by the plaintiffs. While it is not possible to estimate the loss, or range of loss, if any, that may be incurred in connection with any of the various proceedings at this time, it is possible that individual actions may result in a loss having a material adverse effect on the Company's financial condition or results of operations.

(b) Commitment:

The Company has entered into subscription agreements to commit up to \$6.0 million of capital to allow for participation in limited liability investments which invest principally in income-producing real estate. At March 31, 2014, the unfunded commitment was \$1.5 million.



KINGSWAY FINANCIAL SERVICES INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations  
Forward Looking Statements

Management's Discussion and Analysis includes "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are not historical facts, and involve risks and uncertainties that could cause actual results to differ materially from those expected and projected. Words such as "expects", "believes", "anticipates", "intends", "estimates", "seeks" and variations and similar words and expressions are intended to identify such forward looking statements. Such forward looking statements relate to future events or future performance, but reflect Kingsway management's current beliefs, based on information currently available. A number of factors could cause actual events, performance or results to differ materially from the events, performance and results discussed in the forward looking statements. For information identifying important factors that could cause actual results to differ materially from those anticipated in the forward looking statements, see Kingsway's securities filings, including its Annual Report on Form 10-K for the year ended December 31, 2013 ("2013 Annual Report"). The Company's securities filings can be accessed on the Canadian Securities Administrators' website at [www.sedar.com](http://www.sedar.com), and on the EDGAR section of the U.S. Securities and Exchange Commission's website at [www.sec.gov](http://www.sec.gov) or through the Company's website at [www.kingsway-financial.com](http://www.kingsway-financial.com). Except as expressly required by applicable securities law, the Company disclaims any intention or obligation to update or revise any forward looking statements whether as a result of new information, future events or otherwise.

OVERVIEW

Kingsway is a Canadian holding company with operating subsidiaries located in the United States. The Company operates as a merchant bank primarily engaged, through its subsidiaries, in the property and casualty insurance business. Kingsway conducts its business through the following two reportable segments: Insurance Underwriting and Insurance Services.

Effective March 31, 2014, the Company's wholly owned subsidiary, 1347 Property Insurance Holdings, Inc. ("PIH"), formerly known as Maison Insurance Holdings, Inc., completed an initial public offering of its common stock. Upon completion of the transaction, the Company maintained a 28.7% interest in the common shares of PIH, which is reported as investment in investee in the consolidated balance sheets. The earnings of PIH are included in the consolidated statements of operations through the March 31, 2014 transaction date. Prior to the transaction, PIH was included in the Insurance Underwriting segment. As a result of the disposal of the Company's majority interest in PIH on March 31, 2014, all segmented information has been restated to exclude PIH from the Insurance Underwriting segment.

Insurance Underwriting includes the following subsidiaries of the Company: Mendota Insurance Company ("Mendota"), Mendakota Insurance Company ("Mendakota"), Universal Casualty Company ("UCC"), Kingsway Amigo Insurance Company ("Amigo") and Kingsway Reinsurance Corporation. In September 2013, Kingsway Reinsurance (Bermuda) Ltd., formerly included in Insurance Underwriting, was liquidated. Throughout Management's Discussion and Analysis, the term "Insurance Underwriting" is used to refer to this segment.

Insurance Underwriting actively conducts business in 15 states. For the three months ended March 31, 2014, production in the following states represented 77.1% of the Company's gross premiums written: Florida (17.1%), Texas (17.1%), Illinois (15.3%) Colorado (10.1%), Nevada (9.2%) and California (8.3%).

Insurance Underwriting principally offers personal automobile insurance to drivers who do not meet the criteria for coverage by standard automobile insurers. For the three months ended March 31, 2014, non-standard automobile insurance accounted for 85.2% of the Company's gross premiums written.

The Company previously placed Amigo and UCC into voluntary run-off in 2012 and 2011, respectively. Each of Amigo and UCC has entered into a comprehensive run-off plan which has been approved by its respective state of domicile. Kingsway continues to manage Amigo and UCC in a manner consistent with the run-off plans.

Insurance Services includes the following subsidiaries of the Company: Assigned Risk Solutions Ltd. ("ARS"), IWS Acquisition Corporation ("IWS") and Trinity Warranty Solutions LLC ("Trinity"). Throughout Management's Discussion and Analysis, the term "Insurance Services" is used to refer to this segment.

ARS is a licensed property and casualty agent, full service managing general agent and third-party administrator focused primarily on the assigned risk market. ARS is licensed to administer business in 22 states but generates its revenues primarily by operating in the states of New York and New Jersey.

KINGSWAY FINANCIAL SERVICES INC.

IWS is a licensed motor vehicle service agreement company and is a provider of after-market vehicle protection services distributed by credit unions in 26 states to their members.

Trinity is a provider of warranty products and maintenance support to consumers and businesses in the heating, ventilation, air conditioning ("HVAC") and refrigeration industry. Trinity distributes its warranty products through original equipment manufacturers, HVAC distributors and commercial and residential contractors. Trinity distributes its maintenance support directly through corporate owners of retail spaces throughout the United States.

NON-U.S. GAAP FINANCIAL MEASURES

Throughout this quarterly report, we present our operations in the way we believe will be most meaningful, useful and transparent to anyone using this financial information to evaluate our performance. In addition to the U.S. GAAP presentation of net loss, we show certain statutory reporting information and other non-U.S. GAAP financial measures that we believe are valuable in managing our business and drawing comparisons to our peers. These measures are operating income (loss), gross premiums written, net premiums written and underwriting ratios.

Following is a list of non-U.S. GAAP measures found throughout this report with their definitions, relationships to U.S. GAAP measures and explanations of their importance to our operations.

Operating Income (Loss)

Operating income (loss) represents one measure of the pretax profitability of our segments and is derived by subtracting direct segment expenses from direct segment revenues. Revenues and expenses are presented in the consolidated statements of operations but are not subtotaled by segment. However, this information is available in total and by segment in Note 18, "Segmented Information," to the unaudited consolidated interim financial statements, regarding reportable segment information. The nearest comparable U.S. GAAP measure is loss before income tax expense (benefit) which, in addition to operating income (loss), includes net investment income, net realized gains (losses), other income, general and administrative expenses, restructuring expense, interest expense, amortization of intangible assets, contingent consideration expense, gain (loss) on change in fair value of debt, loss on disposal of subsidiary, loss on buy-back of debt and equity in net income of investee. A reconciliation of operating income (loss) to loss before income tax expense (benefit) for the three months ended March 31, 2014 and 2013 is presented in Table 1 of the "Results of Continuing Operations" section of Management's Discussion and Analysis.

Gross Premiums Written

While net premiums earned is the related U.S. GAAP measure used in the consolidated statements of operations, gross premiums written is the component of net premiums earned that measures insurance business produced before the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an overall gauge of gross business volume in Insurance Underwriting.

Net Premiums Written

While net premiums earned is the related U.S. GAAP measure used in the consolidated statements of operations, net premiums written is the component of net premiums earned that measures the difference between gross premiums written and the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an indication of retained or net business volume in Insurance Underwriting.

Underwriting Ratios

Kingsway, like many insurance companies, analyzes performance based on underwriting ratios such as loss and loss adjustment expense ratio, expense ratio and combined ratio. The loss and loss and adjustment expense ratio is derived by dividing the amount of net loss and loss adjustment expenses incurred by net premiums earned. The expense ratio is derived by dividing the sum of commissions and premium taxes, general and administrative expenses and policy fee income by net premiums earned. The combined ratio is the sum of the loss and loss adjustment expense ratio and the expense ratio. A combined ratio below 100% demonstrates underwriting profit whereas a combined ratio over 100% demonstrates underwriting loss.

## KINGSWAY FINANCIAL SERVICES INC.

## Critical Accounting Estimates and Assumptions

The preparation of unaudited consolidated interim financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect application of policies and the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ from these estimates. Estimates and their underlying assumptions are reviewed on an ongoing basis. Changes in estimates are recorded in the accounting period in which they are determined. The critical accounting estimates and assumptions in the accompanying unaudited consolidated interim financial statements include the provision for unpaid loss and loss adjustment expenses, valuation of fixed maturities and equity investments, valuation of deferred income taxes, valuation of intangible assets, goodwill recoverability, deferred acquisition costs, fair value assumptions for debt obligations, and contingent consideration.

The Company's critical accounting estimates and assumptions are described in Management's Discussion and Analysis of Financial Condition and Results of Operations included in the 2013 Annual Report. There has been no material change subsequent to December 31, 2013 to the information previously disclosed in the 2013 Annual Report with respect to these critical accounting estimates and assumptions.

## RESULTS OF CONTINUING OPERATIONS

A reconciliation of total segment operating income (loss) to net loss for the three months ended March 31, 2014 and 2013 is presented in Table 1 below:

Table 1 Segment Income (Loss)

For the three months ended March 31 (in millions of dollars)

|  | For the three months ended March 31, |          |         |
|--|--------------------------------------|----------|---------|
|  | 2014                                 | 2013     | Change  |
| Segment operating income (loss)                          |                                      |          |         |
| Insurance Underwriting                                   | 0.3                                  | (3.0)    | ) 3.3   |
| Insurance Services                                       | 1.9                                  | 1.9      | —       |
| Total segment operating income (loss)                    | 2.2                                  | (1.1)    | ) 3.3   |
| Net investment income                                    | 0.4                                  | 0.6      | (0.2)   |
| Net realized gains (losses)                              | —                                    | (1.4)    | ) 1.4   |
| Other income and expenses not allocated to segments, net | (0.5)                                | ) (4.4)  | ) 3.9   |
| Interest expense   | (1.4)                                | ) (1.8)  | ) 0.4   |
| Amortization of intangible assets                        | (0.4)                                | ) (0.6)  | ) 0.2   |
| Contingent consideration expense                         | (0.3)                                | ) (0.2)  | ) (0.1) |
| Gain (loss) on change in fair value of debt              | 0.6                                  | (9.0)    | ) 9.6   |
| Loss on disposal of subsidiary                           | (1.2)                                | ) —      | (1.2)   |
| Equity in net income of investee                         | —                                    | 0.3      | (0.3)   |
| Loss before income tax expense (benefit)                 | (0.6)                                | ) (17.6) | ) 17.0  |
| Income tax expense (benefit)                             | 0.4                                  | (0.3)    | ) 0.7   |
| Net loss   | (1.0)                                | ) (17.3) | ) 16.3  |

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Net Loss

In the first quarter of 2014, we incurred a net loss of \$1.0 million compared to a net loss of \$17.3 million in the first quarter of 2013. The net loss for the three months ended March 31, 2014 is attributable to corporate general expenses, interest expense, and loss on disposal of subsidiary, offset by operating income in Insurance Services and a gain on the change in fair value of debt. The net loss for the three months ended March 31, 2013 is due to operating losses in Insurance Underwriting, corporate general expenses, interest expense and loss on the change in fair value of debt, offset by operating income in Insurance Services.

Insurance Underwriting

For the three months ended March 31, 2014, Insurance Underwriting gross premiums written were \$32.7 million compared to \$43.1 million for the three months ended March 31, 2013, representing a 24.1% decrease. Net premiums written increased 15.7% to \$36.8 million for the three months ended March 31, 2014 compared with \$31.8 million for the three months ended March 31, 2013. Net premiums earned increased 2.2% to \$27.8 million for the three months ended March 31, 2014 compared with \$27.2 million for the three months ended March 31, 2013.

The decrease in gross premiums written is the result of a decrease in non-standard and commercial automobile premium volumes at Amigo reflecting the actions begun by the Company during the fourth quarter of 2012 to place Amigo into voluntary run-off. The increase in net premiums written and earned is due to increased premium volumes at Mendota and Mendakota as a result of the termination of their quota share reinsurance agreement effective January 1, 2014, offset by decreased premium volumes at Amigo as a result of their run-off plan.

The Insurance Underwriting operating income increased to \$0.3 million for the three months ended March 31, 2014 compared to a loss of \$3.0 million for the three months ended March 31, 2013. The increase in operating income for the three months ended March 31, 2014 is primarily attributed to a decrease in commissions, general expenses and restructuring expenses during the first quarter of 2014 compared to the first quarter of 2013.

The Insurance Underwriting loss and loss adjustment expense ratio for the first quarter of 2014 was 68.0% compared to 67.5% for the first quarter of 2013. The increase in the loss and loss adjustment expense ratio for the three months ended March 31, 2014 is primarily due to the increase in unpaid loss and loss adjustment expenses recorded for the three months ended March 31, 2014 compared to the three months ended March 31, 2013.

The Insurance Underwriting expense ratio was 31.4% for the first quarter of 2014 compared to 43.8% for the first quarter of 2013. The decrease in the expense ratio for the three months ended March 31, 2014 is primarily due to the termination of the quota share treaty at Mendota in addition to an overall reduction in general expenses and restructuring expenses. The Insurance Underwriting expense ratio includes policy fee income of \$2.0 million and \$2.3 million for the three months ended March 31, 2014 and 2013, respectively.

The Insurance Underwriting combined ratio was 99.4% in the first quarter 2014 compared with 111.3% in the first quarter of 2013, reflecting the dynamics which affected the loss and loss adjustment expense ratio and expense ratio. Insurance Services

The Insurance Services service fee and commission income increased 12.2% to \$14.7 million for the three months ended March 31, 2014 compared with \$13.1 million for the three months ended March 31, 2013. This increase was primarily driven by the inclusion of Trinity in first quarter of 2014 following its acquisition during the second quarter of 2013. The Insurance Services operating income was \$1.9 million for the three months ended March 31, 2014 compared with \$1.9 million for the three months ended March 31, 2013.

Net Investment Income

Net investment income was \$0.4 million in the first quarter of 2014 compared to \$0.6 million in the first quarter of 2013. The decrease for the three months ended March 31, 2014 is primarily a result of a decline in the Company's fixed maturities, which resulted from reduced volumes of business in Insurance Underwriting. Additionally, yields on fixed maturities remain at historically low levels such that reinvestment of maturing investments occurs at yields lower than the yields on the maturing investments.

Net Realized Gains (Losses)

The Company incurred net realized gains in the first quarter of 2014 of \$0.0 million compared to net realized losses of \$1.4 million in the first quarter of 2013. The net realized gains in 2014 resulted from the liquidation of equity investments and fixed maturities in Insurance Underwriting. The net realized losses in 2013 resulted primarily from

the sale of Atlas Financial Holdings, Inc. ("Atlas") common stock during the first quarter of 2013. As more fully described in Note 7, "Investment in Investee," to the

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unaudited consolidated interim financial statements, the Company realized a loss of \$1.7 million during the first quarter of 2013 related to the sale of Atlas common stock.

Other Income and Expenses not Allocated to Segments, Net

Other income and expenses not allocated to segments was a net expense of \$0.5 million in the first quarter of 2014 compared to \$4.4 million in the first quarter of 2013. The decrease in net expense for the three months ended March 31, 2014 is primarily due \$3.8 million more of income related to PIH for the three months ended March 31, 2014 compared to the three months ended March 31, 2013. As further discussed in Note 5, "Acquisition and Disposition," to the unaudited consolidated interim financial statements, effective March 31, 2014, PIH completed an initial public offering of its common stock. The earnings of PIH are included in the consolidated statements of operations through the March 31, 2014 transaction date. Prior to the transaction, PIH was included in the Insurance Underwriting segment. As a result of the disposal of the Company's majority interest in PIH on March 31, 2014, all segmented information has been restated to exclude PIH from the Insurance Underwriting segment and to include its earnings in other income and expenses not allocated to segments, net.

Interest Expense

Interest expense for the first quarter of 2014 was \$1.4 million compared to \$1.8 million in the first quarter of 2013. The decrease is attributable to the partial redemption in October 2013 and the redemption in February 2014 of the remaining outstanding principal balance on the senior unsecured debentures due February 1, 2014.

Amortization of Intangible Assets

The Company's intangible assets with definite useful lives are amortized over their estimated useful lives. Amortization of intangible assets was \$0.4 million for the first quarter of 2014 compared to \$0.6 million in the first quarter of 2013. The decrease is primarily attributed to less amortization expense related to the IWS vehicle service agreement ("VSA") in-force intangible asset for the three months ended March 31, 2014 compared to the same period in 2013. The VSA in-force asset is amortized over a seven-year term as the corresponding deferred service fees acquired are earned as revenue.

Contingent Consideration Expense

Contingent consideration expense was \$0.3 million for the first quarter of 2014 compared to \$0.2 million in the first quarter of 2013. The increase is due to the inclusion of expense related to the Trinity contingent consideration liability acquired during the second quarter of 2013. See Note 5, "Acquisition and Disposition," to the unaudited consolidated interim financial statements, for further details.

Gain (Loss) on Change in Fair Value of Debt

The gain on change in fair value of debt amounted to \$0.6 million in the first quarter of 2014 compared to a loss of \$9.0 million in the first quarter of 2013. The gain for the first quarter of 2014 is due to a decrease in the fair value of the Company's LROC preferred units, whereas the 2013 loss for the first quarter is due to an increase in the fair values of the Company's senior unsecured debentures, subordinated debt and LROC preferred units.

Loss on Disposal of Subsidiary

Effective March 31, 2014, the Company's wholly owned subsidiary, PIH, completed an initial public offering of its common stock. Upon completion of the transaction, the Company maintained a 28.7% interest in the common shares of PIH. As a result of the disposal, the Company recognized a loss of \$1.2 million for the three months ended March 31, 2014. See Note 5, "Acquisition and Disposition," to the unaudited consolidated interim financial statements, for further details.

Equity in Net Income of Investee

As discussed further in Note 7, "Investment in Investee," to the unaudited consolidated interim financial statements, during the second quarter of 2013, the Company discontinued the use of the equity method of accounting for its former investee, Atlas. Prior to discontinuing the use of the equity method of accounting for Atlas, the Company used a reporting lag of three months to report its proportionate share of Atlas' results. Accordingly, equity in net income of investee recorded during the first quarter of 2013 of \$0.3 million relates to the Company's proportionate share of Atlas' results reported for the three months ended December 31, 2012.

Income Tax Expense (Benefit)

Income tax expense for the first quarter of 2014 was \$0.4 million compared to income tax benefit of \$0.3 million in the first quarter of 2013. The increase in income tax expense for the three months ended March 31, 2014 is primarily attributable to a valuation



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allowance tax benefit adjustment recorded in 2013, an increase in state income tax expense recorded in 2014 and a tax benefit recorded in 2014 for a Canadian income tax refund.

## INVESTMENTS

## Portfolio Composition

All of our investments in fixed maturities and equity investments are classified as available-for-sale and are reported at fair value. At March 31, 2014, we held cash and cash equivalents and investments with a carrying value of \$140.6 million. As of March 31, 2014, we held an investments portfolio comprised primarily of fixed maturities issued by the U.S. Government, government agencies and high quality corporate issuers. Investments held by our insurance subsidiaries must comply with applicable domiciliary state regulations that prescribe the type, quality and concentration of investments. Our U.S. operations typically invest in U.S. dollar-denominated instruments to mitigate their exposure to currency rate fluctuations.

Table 2 below summarizes the carrying value of investments, including cash and cash equivalents, at the dates indicated.

TABLE 2 Carrying value of investments, including cash and cash equivalents  
(in millions of dollars, except for percentages)

| Type of investment  | March 31, 2014 | % of Total | December 31, 2013 | % of Total |
|---|----------------|------------|-------------------|------------|
| Fixed maturities:   |                |            |                   |            |
| U.S. government, government agencies and authorities            | 15.8           | 11.2 %     | 18.4              | 11.0 %     |
| Canadian government   | 4.2            | 3.0 %      | 4.1               | 2.4 %      |
| States municipalities and political subdivisions                | 6.2            | 4.5 %      | 6.2               | 3.7 %      |
| Mortgage-backed   | 2.0            | 1.4 %      | 2.0               | 1.2 %      |
| Asset-backed securities and collateralized mortgage obligations | 4.5            | 3.2 %      | 4.0               | 2.4 %      |
| Corporate   | 18.7           | 13.3 %     | 19.5              | 11.6 %     |
| Total fixed maturities  | 51.4           | 36.6 %     | 54.2              | 32.3 %     |
| Common stock  | 10.0           | 7.1 %      | 7.1               | 4.2 %      |
| Limited liability investments                                   | 4.7            | 3.3 %      | 4.4               | 2.6 %      |
| Other investments   | 2.0            | 1.4 %      | 3.0               | 1.8 %      |
| Short-term investments  | 0.4            | 0.3 %      | 0.5               | 0.3 %      |
| Total investments   | 68.5           | 48.7 %     | 69.2              | 41.2 %     |
| Cash and cash equivalents                                       | 72.1           | 51.3 %     | 98.6              | 58.8 %     |
| Total   | 140.6          | 100.0 %    | 167.8             | 100.0 %    |

## Liquidity and Cash Flow Risk

Table 3 below summarizes the fair value by contractual maturities of the fixed maturities portfolio, excluding cash and cash equivalents, at March 31, 2014 and December 31, 2013.

TABLE 3 Fair value of fixed maturities by contractual maturity date  
(in millions of dollars)

|                                  | March 31, 2014 | % of Total | December 31, 2013 | % of Total |
|----------------------------------|----------------|------------|-------------------|------------|
| Due in less than one year        | 17.6           | 34.2 %     | 14.1              | 26.0 %     |
| Due in one through five years    | 31.3           | 60.9 %     | 36.6              | 67.5 %     |
| Due after five through ten years | 0.6            | 1.2 %      | 1.5               | 2.8 %      |
| Due after ten years              | 1.9            | 3.7 %      | 2.0               | 3.7 %      |
| Total                            | 51.4           | 100.0 %    | 54.2              | 100.0 %    |



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At March 31, 2014, 95.1% of fixed maturities, including treasury bills, government bonds and corporate bonds, had contractual maturities of five years or less. Actual maturities may differ from contractual maturities because certain issuers have the right to call or prepay obligations with or without call or prepayment penalties. The Company holds cash and high-grade short-term assets which, along with fixed maturities, management believes are sufficient in amount for the payment of unpaid loss and loss adjustment expenses and other operating subsidiary obligations on a timely basis. In the event that additional cash is required to meet obligations to our policyholders and customers, we believe that the high-quality, liquid investments in the portfolios provide us with sufficient liquidity.

## Market Risk

Market risk is the risk that we will incur losses due to adverse changes in interest or currency exchange rates and equity prices. Given our U.S. operations typically invest in U.S. dollar denominated instruments and maintain a relatively insignificant investment in equity instruments, our primary market risk exposures in the investments portfolio are to changes in interest rates.

Because the investments portfolio is comprised of primarily fixed maturity instruments that are usually held to maturity, periodic changes in interest rate levels generally impact our financial results to the extent that the investments are recorded at market value and reinvestment yields are different than the original yields on maturing instruments. During periods of rising interest rates, the market values of the existing fixed maturities will generally decrease. The reverse is true during periods of declining interest rates.

## Credit Risk

Credit risk is defined as the risk of financial loss due to failure of the other party to a financial instrument to discharge an obligation. Credit risk arises from our positions in short-term investments, corporate debt instruments and government bonds.

The Investment and Capital Committee of the Board of Directors is responsible for the oversight of key investment policies and limits. These policies and limits are subject to annual review and approval by the Investment and Capital Committee. The Investment and Capital Committee is also responsible for ensuring that these policies are implemented and that procedures are in place to manage and control credit risk.

Table 4 below summarizes the composition of the fair values of fixed maturities, excluding cash and cash equivalents, at March 31, 2014 and December 31, 2013, by rating as assigned by Standard and Poor's ("S&P") or Moody's Investors Service ("Moody's"). Fixed maturities consist of predominantly high-quality instruments in corporate and government bonds with approximately 93.2% of those investments rated 'A' or better at March 31, 2014. During 2012, the Company reinvested cash into certain fixed maturities rated BBB/Baa. These investment grade fixed maturities purchased provide a better yield while maintaining compliance with conservative credit risk guidelines adopted by the Company.

TABLE 4 Credit ratings of fixed maturities

| Rating (S&P/Moody's)            | March 31, 2014 | December 31, 2013 |   |
|---------------------------------|----------------|-------------------|---|
| AAA/Aaa                         | 52.2           | % 52.6            | % |
| AA/Aa                           | 9.9            | 11.4              |   |
| A/A                             | 31.1           | 29.6              |   |
| Percentage rated A/A2 or better | 93.2           | % 93.6            | % |
| BBB/Baa                         | 6.8            | 6.4               |   |
| Total                           | 100.0          | % 100.0           | % |

## Other-Than-Temporary Impairment

The Company performs a quarterly analysis of its investment portfolio to determine if declines in market value are other-than-temporary. Further information regarding our detailed analysis and factors considered in establishing an other-than-temporary impairment on an investment is discussed within Note 6, "Investments," to the unaudited consolidated interim financial statements.

As a result of the analysis performed by the Company to determine declines in market value that are other-than-temporary, there were no write-downs for other-than-temporary impairments related to investments for the three months ended March 31, 2014 and March 31, 2013.

The length of time an individual investment may be held in an unrealized loss position may vary based on the opinion of the investment manager and their respective analyses related to valuation and to the various credit risks that may prevent us from recapturing the principal investment. In the case of an individual investment with a maturity date where the investment manager determines that there is little or no risk of default prior to the maturity of a holding, we would elect to hold the investment in an

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unrealized loss position until the price recovers or the investment matures. In situations where facts emerge that might increase the risk associated with recapture of principal, the Company may elect to sell investments at a loss.

At March 31, 2014, the gross unrealized losses for fixed maturities and equity investments amounted to \$0.3 million, and there were no unrealized losses attributable to non-investment grade fixed maturities.

At each of March 31, 2014 and December 31, 2013, all unrealized losses on individual investments were considered temporary. Fixed maturities in unrealized loss positions continued to pay interest and were not subject to material changes in their respective debt ratings. We concluded that default risk did not exist at the time and, therefore, the declines in value were considered temporary. As we have the capacity to hold these investments to maturity, no impairment provision was considered necessary.

**Limited Liability Investments**

The Company owns investments in limited liability companies ("LLCs") and a limited partnership ("LP") that primarily invest in income-producing real estate. The Company's investments in the LLCs and LP are reported as limited liability investments in the consolidated balance sheets. The real estate investments are held on a triple net lease basis whereby the lessee agrees to pay all real estate taxes, building insurance and maintenance. The real estate investments yield between 7.5% - 8% minimum preferred return on invested capital. Table 5 below presents additional information pertaining to the limited liability investments at March 31, 2014 and December 31, 2013.

TABLE 5 Limited liability investments

(in millions of dollars)

|                                | Unfunded       | Carrying Value |                   |
|--------------------------------|----------------|----------------|-------------------|
|                                | Commitment     | March 31, 2014 | December 31, 2013 |
| Limited liability investments: | March 31, 2014 | March 31, 2014 | December 31, 2013 |
| Real estate held through LP    | 1.5            | 4.4            | 4.1               |
| Other                          | —              | 0.3            | 0.3               |
| Total                          | 1.5            | 4.7            | 4.4               |

**PROPERTY AND CASUALTY UNPAID LOSS AND LOSS ADJUSTMENT EXPENSES**

Property and casualty unpaid loss and loss adjustment expenses represent the estimated liabilities for reported loss events, incurred but not reported ("IBNR") loss events and the related estimated loss adjustment expenses.

Tables 6 and 7 present distributions, by line of business, of the provision for property and casualty unpaid loss and loss adjustment expenses gross and net of external reinsurance, respectively.

TABLE 6 Provision for property and casualty unpaid loss and loss adjustment expenses - gross

(in millions of dollars)

| Line of Business        | March 31, 2014 | December 31, 2013 |
|-------------------------|----------------|-------------------|
| Non-standard automobile | 68.3           | 75.5              |
| Commercial automobile   | 6.2            | 6.7               |
| Other                   | 2.8            | 2.3               |
| Total                   | 77.3           | 84.5              |

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TABLE 7 Provision for property and casualty unpaid loss and loss adjustment expenses - net of reinsurance recoverable

(in millions of dollars)

| Line of Business        | March 31, 2014 | December 31, 2013 |
|-------------------------|----------------|-------------------|
| Non-standard automobile | 62.7           | 67.8              |
| Commercial automobile   | 6.0            | 6.4               |
| Other                   | 2.8            | 2.4               |
| Total                   | 71.5           | 76.6              |

## Non-Standard Automobile

At March 31, 2014 and December 31, 2013, the gross provisions for property and casualty unpaid loss and loss adjustment expenses for our non-standard automobile business were \$68.3 million and \$75.5 million, respectively.

The decrease primarily reflects the actions begun by the Company during the fourth quarter of 2012 to place Amigo into voluntary run-off as well as the payment of claims related to UCC's continuing voluntary run-off.

## Commercial Automobile

At March 31, 2014 and December 31, 2013, the gross provisions for property and casualty unpaid loss and loss adjustment expenses for our commercial automobile business were \$6.2 million and \$6.7 million, respectively. The decrease primarily reflects the actions begun by the Company during the fourth quarter of 2012 to place Amigo into voluntary run-off as well as the payment of claims related to UCC's continuing voluntary run-off.

Information with respect to development of our provision for prior years' property and casualty unpaid loss and loss adjustment expenses is presented in Table 8.

TABLE 8 Decrease in prior years' provision for property and casualty unpaid loss and loss adjustment expenses (in millions of dollars)

|  | Three months ended March 31, |       |
|--|------------------------------|-------|
|  | 2014                         | 2013  |
| Favorable change in provision for property and casualty unpaid loss and loss adjustment expenses for prior accident years: | (0.6                         | )(0.8 |

For the three months ended March 31, 2014, the Company reported \$0.6 million of favorable development for property and casualty unpaid loss and loss adjustment expenses from prior accident years. For the three months ended March 31, 2013, the Company reported \$0.8 million of favorable development for property and casualty unpaid loss and loss adjustment expenses from prior accident years. The favorable development reported for the three months ended March 31, 2014 was primarily related to the decrease in property and casualty unpaid loss and loss adjustment expenses at Amigo. The favorable development reported for the three months ended March 31, 2013 was primarily related to the decrease in property and casualty unpaid loss and loss adjustment expenses at UCC.

The Company cannot predict whether property and casualty unpaid loss and loss adjustment expenses will develop favorably or unfavorably from the amounts reported in the Company's unaudited consolidated interim financial statements. The Company believes that any such development will not have a material effect on the Company's consolidated equity but could have a material effect on the Company's consolidated financial results for a given period. See the "Critical Accounting Estimates and Assumptions" section of Management's Discussion and Analysis of Financial Condition and Results of Operations in the 2013 Annual Report for additional information pertaining to the Company's process of estimating the provision for unpaid loss and loss adjustment expenses.

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RECENTLY ISSUED ACCOUNTING STANDARDS

See Note 4, "Recently Issued Accounting Standards," to the unaudited consolidated interim financial statements, for discussion of certain accounting standards that may be applicable to the Company's current and future consolidated financial statements.

LIQUIDITY AND CAPITAL RESOURCES

The purpose of liquidity management is to ensure that there is sufficient cash to meet all financial commitments and obligations as they fall due. The liquidity requirements of the Company and its subsidiaries have been met primarily by funds generated from operations, disposal of discontinued operations, investment maturities and income and other returns received on investments. Cash provided from these sources is used primarily for loss and loss adjustment expense payments, debt servicing and other operating expenses. The timing and amount of payments for loss and loss adjustment expenses may differ materially from our provisions for unpaid loss and loss adjustment expenses, which may create increased liquidity requirements.

Cash Flows

During the three months ended March 31, 2014, the net cash used in operating activities as reported on the unaudited consolidated statements of cash flows was \$8.9 million. This use of cash can be explained primarily by the net loss of \$1.0 million; the decrease in unearned premiums reserve of \$7.6 million, primarily due to the disposal of PIH; and the decrease in the provision for unpaid loss and loss adjustment expenses of \$7.2 million; offset by the increase in prepaid reinsurance premiums of \$6.7 million as a result of the termination of the quota share reinsurance agreement at Mendota and Mendakota effective January 1, 2014.

During the three months ended March 31, 2014, the net cash used in investing activities as reported on the unaudited consolidated statements of cash flows was \$9.6 million. This use of cash was driven primarily by the acquisition of investee and purchases of fixed maturities and equity investments in excess of proceeds from sales and maturities of fixed maturities and equity investments. As previously explained, the Company's insurance subsidiaries hold investments portfolios comprised primarily of fixed maturities issued by the U.S. Government, government agencies and high-quality corporate issuers which are of generally short duration and are highly liquid which enables the insurance subsidiaries to meet their liquidity needs.

During the three months ended March 31, 2014, the net cash used in financing activities as reported on the unaudited consolidated statements of cash flows was \$8.0 million. This use of cash is attributed to the net proceeds received from the Company's private placement of \$6.4 million, as further discussed in Note 16, "Shareholders' Equity," to the unaudited consolidated interim financial statements, offset by the redemption of \$14.4 million of par value of senior unsecured debentures due February 1, 2014.

In summary, as reported on the unaudited consolidated statements of cash flows, the Company's net decrease in cash and cash equivalents during the three months ended March 31, 2014 was \$26.5 million.

The Company's Insurance Underwriting subsidiaries fund their obligations primarily through premium and investment income and maturities in the investments portfolios. The Company's Insurance Services subsidiaries fund their obligations primarily through service fee and commission income. As a holding company, Kingsway funds its obligations, which primarily consist of interest payments on debt as well as holding company operating expenses, primarily through disposal of discontinued operations and investment in investee, as well as from receipt of dividends from its non-insurance subsidiaries. On the other hand, the operating insurance subsidiaries require regulatory approval for the return of capital and, in certain circumstances, prior to the payment of dividends. At March 31, 2014, the U.S. insurance subsidiaries of the Company were restricted from making any dividend payments without regulatory approval pursuant to the domiciliary state insurance regulations.

On February 3, 2014, the Company closed on its previously announced private placement totaling \$6.6 million. At closing, the Company received gross proceeds of \$6.6 million, resulting from the sale and issuance of 262,876 units for a purchase price of \$25.00 per unit. Net proceeds to the Company were \$6.4 million after deducting expenses. Each unit consists of one class A convertible preferred share, series 1 (the "Preferred Shares"), and 6.25 common share class C purchase warrants. Each Preferred Share is convertible into 6.25 common shares at a conversion price of \$4.00 per common share any time at the option of the holder prior to April 1, 2021. The maximum number of common shares issuable upon conversion of the Preferred Shares is 1,642,975 common shares. Each warrant will

entitle the subscriber to purchase one common share of Kingsway at a price of \$5.00 per common share at any time after September 16, 2016 and prior to expiry on September 15, 2023.

**Debt Buy-backs**

The Company launched a debt buy-back initiative during 2009, pursuant to which it has retired a substantial amount of its outstanding debt. No debt repurchases were made during the first quarter of 2014. During the first quarter of 2013, the Company purchased for \$0.6 million, including accrued interest, \$0.6 million of par value of its senior unsecured debentures due February 1, 2014 with



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a carrying value of \$0.6 million, including accrued interest, recording a loss of \$0.0 million. The Company subsequently canceled the acquired debentures.

Regulatory Capital

In the United States, a risk-based capital ("RBC") formula is used by the National Association of Insurance Commissioners ("NAIC") to identify property and casualty insurance companies that may not be adequately capitalized. Most states, including the domiciliary states of our insurance subsidiaries, have adopted the NAIC RBC requirements. In general, insurers reporting surplus as regards policyholders below 200% of the authorized control level, as defined by the NAIC, at December 31 are subject to varying levels of regulatory action, including discontinuation of operations. As of December 31, 2013, surplus as regards policyholders reported by each of our insurance subsidiaries exceeded the 200% threshold.

Our reinsurance subsidiary, which is domiciled in Barbados, is required by the regulator in Barbados to maintain minimum capital levels. As of March 31, 2014, the capital maintained by Kingsway Reinsurance Corporation was in excess of the regulatory capital requirements in Barbados.

On June 7, 2013, the Company received notification from the New York Stock Exchange ("NYSE") of the Company's non-compliance with certain NYSE standards for continued listing of its common shares. Specifically, Kingsway is below the NYSE's continued listing criteria because its average total market capitalization over a recent 30 consecutive trading day period was less than \$50 million at the same time that reported shareholders' equity was below \$50 million. Under the NYSE's continued listing criteria, a NYSE-listed company must maintain average market capitalization of not less than \$50 million over a 30 consecutive trading day period or reported shareholders' equity of not less than \$50 million.

The Company had 90 days from the date of the notice to submit a business plan to the NYSE demonstrating its ability to achieve compliance with the listing standards within 18 months of receiving the notice. The Company submitted a business plan to the NYSE on July 17, 2013, intended to demonstrate its ability to achieve compliance with the listing standards within 18 months of receiving the notice. On October 8, 2013, the NYSE accepted the Company's business plan submission. During such 18-month period, Kingsway's common shares will continue to be listed and traded on the NYSE, subject to compliance with other NYSE continued listing standards; however, the consolidated tape now includes a ".BC" indicator, which will be removed at such time as the Company is deemed compliant with the NYSE's continued listing standards.

The notice from the NYSE does not impact the Company's listing on the Toronto Stock Exchange ("TSX"), and its common shares will continue to be listed and traded on the TSX, subject to compliance with TSX continued listing standards. There can be no assurance that the Company will regain compliance with NYSE listing standards.

KINGSWAY FINANCIAL SERVICES INC.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are a smaller reporting company as defined in Rule 12b-2 of the Exchange Act; therefore, pursuant to Regulation S-K, we are not required to make disclosures under this Item.

Item 4. Controls and Procedures

The Company's management performed an evaluation under the supervision and with the participation of the Company's principal executive officer and the principal financial officer, and completed an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as that term is defined in Rules 13a-15(e) and 15d-15(e), as adopted by the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934, as amended ("the Exchange Act") as of March 31, 2014. Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including the principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosures.

Based on that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective.

During the Company's last fiscal quarter, there were no changes in internal control over financial reporting that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

KINGSWAY FINANCIAL SERVICES INC.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

Information concerning pending legal proceedings is incorporated herein by reference to Note 22, "Commitments and Contingencies," to the unaudited consolidated interim financial statements in Part I of this Form 10-Q.

**Item 1A. Risk Factors**

There are no material changes with respect to those risk factors previously disclosed in our 2013 Annual Report.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None

KINGSWAY FINANCIAL SERVICES INC.

Item 6. Exhibits

- 4.1 Excerpt of the Articles of Amendment to the Articles of Incorporation of the Company (included as Exhibit 4.1 to the Company's Current Report on Form 8-K filed on December 27, 2013 and incorporated by reference herein).
- 4.2 Form of Common Stock Series C Warrant Agreement (included as Exhibit 4.2 to the Company's Current Report on Form 8-K filed on December 27, 2013 and incorporated by reference herein).
- 10.1 Form of Subscription Agreement (included as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on December 27, 2013 and incorporated by reference herein).
- 10.2 Registration Rights Agreement, dated February 3, 2014, by and among the Company and the other parties signatory thereto (included as Exhibit 10.2 to the Company's Current Report on Form 8-K filed on February 4, 2014 and incorporated by reference herein).
- 31.1 Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase
- 101.DEF XBRL Taxonomy Extension Definition Linkbase
- 101.LAB XBRL Taxonomy Extension Label Linkbase
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase

KINGSWAY FINANCIAL SERVICES INC.

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.

KINGSWAY FINANCIAL SERVICES INC.

Date: May 8, 2014

By: /s/ Larry G. Swets, Jr.  
Larry G. Swets, Jr., President, Chief Executive Officer and Director  
(principal executive officer)

Date: May 8, 2014

By: /s/ William A. Hickey, Jr.  
William A. Hickey, Jr., Chief Financial Officer and Executive Vice  
President  
(principal financial officer)