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MERCHANTS GROUP INC
Form 10-Q
May 08, 2002

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

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
OR
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM _____ TO _____.

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2002

COMMISSION FILE NUMBER 1-9640

MERCHANTS GROUP, INC.
(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of incorporation or organization)

16-1280763
(I.R.S. Employer Identification No.)

250 MAIN STREET, BUFFALO, NEW YORK
(Address of principal executive offices)
14202

(Zip Code)
716-849-3333

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of April 30, 2002: 2,110,152 SHARES OF COMMON STOCK.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

MERCHANTS GROUP, INC.

CONSOLIDATED BALANCE SHEET

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(in thousands)

| Assets ----- | December 31, 2001 ----- | March 31, 2002 ----- (unaudited) |
|---|-------------------------------|---|
| Investments: | | |
| Fixed maturities: | | |
| Held to maturity at amortized cost (fair value \$14,035 in 2001 and \$10,939 in 2002) | \$ 13,042 | \$ 10,205 |
| Available for sale at fair value (amortized cost \$178,815 in 2001 and \$180,898 in 2002) | 182,170 | 183,309 |
| Preferred stock at fair value | 9,422 | 9,106 |
| Other long-term investments at fair value | 1,593 | 1,009 |
| Short-term investments | 6,905 | 6,045 |
| | ----- | ----- |
| Total investments | 213,132 | 209,674 |
| Cash | 1,197 | 447 |
| Interest due and accrued | 2,309 | 1,995 |
| Premiums receivable, net of allowance for doubtful accounts of \$431 in 2001 and \$410 in 2002 | 21,685 | 20,602 |
| Deferred policy acquisition costs | 12,354 | 11,292 |
| Ceded reinsurance balances receivable | 18,810 | 19,684 |
| Prepaid reinsurance premiums | 3,559 | 3,212 |
| Deferred income taxes | 4,790 | 5,186 |
| Other assets | 8,727 | 8,606 |
| | ----- | ----- |
| Total assets | \$286,563 ===== | \$280,698 ===== |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED BALANCE SHEET

(in thousands except share amounts)

December 31,
2001

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Liabilities and Stockholders' Equity

| | | |
|--|----|----------|
| Liabilities: | | |
| Reserve for losses and loss adjustment expenses | \$ | 151,355 |
| Unearned premiums | | 50,179 |
| Demand loan | | 200 |
| Payable to affiliate | | 852 |
| Other liabilities | | 15,426 |
| | | ----- |
| Total liabilities | | 218,012 |
| | | ----- |
| Stockholders' equity: | | |
| Common stock, 10,000,000 shares authorized, 2,224,452 shares issued and outstanding at December 31, 2001 and 2,110,152 shares issued and outstanding at March 31, 2002 | | 32 |
| Additional paid in capital | | 35,795 |
| Treasury stock, 1,025,400 shares at December 31, 2001 and 1,139,700 shares at March 31, 2002 | | (20,332) |
| Accumulated other comprehensive income | | 1,812 |
| Accumulated earnings | | 51,244 |
| | | ----- |
| Total stockholders' equity | | 68,551 |
| | | ----- |
| Commitments and contingent liabilities | | - |
| | | ----- |
| Total liabilities and stockholders' equity | \$ | 286,563 |
| | | ===== |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands except per share amounts)

| | Three Months Ended March 31, | |
|-------------------------------|---------------------------------|----------|
| | 2001 | 2002 |
| | ----- | ----- |
| | (unaudited) | |
| Revenues: | | |
| Net premiums earned | \$23,353 | \$23,130 |
| Net investment income | 3,563 | 2,570 |
| Net realized investment gains | 43 | 73 |

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| | | |
|---|--------|--------|
| Other revenues | 137 | 227 |
| | ----- | ----- |
| Total revenues | 27,096 | 26,000 |
| | ----- | ----- |
| Expenses: | | |
| Net losses and loss adjustment expenses | 18,761 | 17,896 |
| Amortization of deferred policy acquisition costs | 6,189 | 6,129 |
| Other underwriting expenses | 1,815 | 1,735 |
| | ----- | ----- |
| Total expenses | 26,765 | 25,760 |
| | ----- | ----- |
| Income before income taxes | 331 | 240 |
| Income tax provision | 119 | 98 |
| | ----- | ----- |
| Net income | \$ 212 | \$ 142 |
| | ===== | ===== |
| Basic and diluted earnings per share | \$.09 | \$.07 |
| | ===== | ===== |
| Weighted average shares outstanding: | | |
| Basic | 2,423 | 2,171 |
| Diluted | 2,425 | 2,174 |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(in thousands)

| | Three Months Ended March 31, | |
|---|---------------------------------|--------|
| | 2001 | 2002 |
| | ----- | ----- |
| | (unaudited) | |
| Net income | \$ 212 | \$ 142 |
| | ----- | ----- |
| Other comprehensive income (loss) before taxes: | | |
| Unrealized gains (losses) on securities | 2,835 | (936) |

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| | | |
|---|----------|----------|
| Reclassification adjustment for gains and losses included in net income | (43) | (73) |
| | ----- | ----- |
| Other comprehensive income (loss) before taxes | 2,792 | (1,009) |
| Income tax provision (benefit) related to items of other comprehensive income (loss) | 1,069 | (381) |
| | ----- | ----- |
| Other comprehensive income (loss) | 1,723 | (628) |
| | ----- | ----- |
| Comprehensive income (loss) | \$ 1,935 | \$ (486) |
| | ===== | ===== |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands)

| | Three Months Ended March 31, | |
|--|---------------------------------|----------|
| | 2001 | 2002 |
| | ----- | ----- |
| | (unaudited) | |
| Common stock, beginning and end | \$ 32 | \$ 32 |
| | ----- | ----- |
| Additional paid in capital, beginning and end: | 35,680 | 35,795 |
| | ----- | ----- |
| Treasury stock: | | |
| Beginning of period | (16,063) | (20,332) |
| Purchase of treasury shares | (234) | (2,434) |
| | ----- | ----- |
| End of period | (16,297) | (22,766) |
| | ----- | ----- |
| Accumulated other comprehensive income (loss): | | |
| Beginning of period | (875) | 1,812 |
| Other comprehensive income (loss) | 1,723 | (628) |
| | ----- | ----- |
| End of period | 848 | 1,184 |
| | ----- | ----- |
| Accumulated earnings: | | |
| Beginning of period | 51,348 | 51,244 |

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| | | |
|----------------------------|-----------|-----------|
| Net income | 212 | 142 |
| Cash dividends | (481) | (223) |
| | ----- | ----- |
| End of period | 51,079 | 51,163 |
| | ----- | ----- |
| Total stockholders' equity | \$ 71,342 | \$ 65,408 |
| | ===== | ===== |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

| | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2001 | 2002 |
| | ----- | ----- |
| | (unaudited) | |
| Cash flows from operations: | | |
| Collection of premiums | \$ 21,659 | \$ 20,392 |
| Payment of losses and loss adjustment expenses | (18,580) | (17,591) |
| Payment of other underwriting expenses | (9,998) | (8,329) |
| Investment income received | 3,967 | 3,032 |
| Investment expenses paid | (142) | (78) |
| Income taxes (paid) recovered | (78) | 376 |
| Other | 134 | 228 |
| | ----- | ----- |
| Net cash used in operations | (3,038) | (1,970) |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Proceeds from fixed maturities sold or matured | 27,365 | 17,931 |
| Purchase of fixed maturities | (26,110) | (17,071) |
| Net (increase) decrease in preferred stock | (1,431) | 149 |
| Net (increase) decrease in other long-term investments | (318) | 583 |
| Net increase in short-term investments | 1,590 | 860 |
| | ----- | ----- |
| Net cash provided by investing activities | 1,096 | 2,452 |
| | ----- | ----- |
| Cash flows from financing activities: | | |
| Settlement of affiliate balances | 2,653 | 1,129 |
| Increase in receivable for securities | - | (104) |
| Increase (decrease) in demand loan, net | - | 400 |

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| | | |
|---|-------|---------|
| Purchase of treasury stock | (234) | (2,434) |
| Cash dividends | (481) | (223) |
| | ----- | ----- |
| Net cash provided by (used in) financing activities | 1,938 | (1,232) |
| | ----- | ----- |
| Decrease in cash | (4) | (750) |
| Cash: | | |
| Beginning of period | 5 | 1,197 |
| | ----- | ----- |
| End of period | \$ 1 | \$ 447 |
| | ===== | ===== |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

RECONCILIATION OF NET INCOME TO NET CASH

PROVIDED BY OPERATIONS

(in thousands)

| | Three Months Ended March 31, | |
|---|---------------------------------|---------|
| | 2001 | 2002 |
| | ----- | ----- |
| | (unaudited) | |
| Net income | \$ 212 | \$ 142 |
| Adjustments: | | |
| Accretion | (247) | 71 |
| Realized investment gains | (43) | (73) |
| (Increase) decrease in assets: | | |
| Interest due and accrued | 570 | 314 |
| Premiums receivable | 1,667 | 1,083 |
| Deferred policy acquisition costs | 772 | 1,062 |
| Ceded reinsurance balances receivable | 716 | (874) |
| Prepaid reinsurance premiums | 1,129 | 347 |
| Deferred income taxes | 31 | (15) |
| Other assets | (690) | 224 |
| Increase (decrease) in liabilities: | | |
| Reserve for losses and loss adjustment expenses | (534) | 1,562 |
| Unearned premiums | (4,040) | (4,355) |
| Other liabilities | (2,581) | (1,458) |
| | ----- | ----- |

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| | | |
|-----------------------------|------------|------------|
| Net cash used in operations | \$ (3,038) | \$ (1,970) |
| | ===== | ===== |

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Principles of Consolidation and Basis of Presentation

The consolidated balance sheet as of March 31, 2002 and the related consolidated statements of operations, of comprehensive income, of changes in stockholders' equity and of cash flows for the three months ended March 31, 2001 and 2002, respectively, are unaudited. In the opinion of management, the interim financial statements reflect all adjustments necessary for a fair presentation of financial position and results of operations. Such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results for a full year.

The consolidated financial statements include the accounts of Merchants Group, Inc. (the Company), its wholly-owned subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH), and M.F.C. of New York, Inc., an inactive premium finance company which is a wholly-owned subsidiary of MNH. The accompanying consolidated financial statements should be read in conjunction with the following notes and the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2001.

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which differ in some respects from those followed in reports to insurance regulatory authorities. All significant intercompany balances and transactions have been eliminated.

2. Related Party Transactions

With the exception of the Chief Operating Officer of MNH, the Company and MNH have no paid employees. Under a management agreement dated September 26, 1986 (the Management Agreement), Merchants Mutual Insurance Company (Mutual), which owned 12.1% of the Company's common stock at March 31, 2002, provides the Company and MNH with the facilities, management and personnel required to manage their day-to-day business. All underwriting, administrative, claims and investment expenses incurred on behalf of Mutual and MNH are shared on an allocated cost basis, determined as follows: for underwriting and administrative expenses, the respective share of total direct premiums written for Mutual and MNH serves as the basis of allocation; for claims expenses, the average number of outstanding claims is used; investment expenses are shared based on each company's share of total invested assets.

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3. Earnings Per Share

Basic and diluted earnings per share were computed by dividing net income by the weighted average number of shares of common stock outstanding during each period, increased by the assumed exercise of 35,500 and 8,000 shares of common stock options in 2002 and 2001, respectively, which would have resulted in 2,660 and 1,844 additional shares outstanding, respectively, assuming the proceeds to the Company from exercise were used to purchase shares of the Company's common stock at its average market value per share during the quarter.

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

Results of Operations for the Three Months Ended March 31, 2002 As Compared to

the Three Months Ended March 31, 2001

Total revenues for the three months ended March 31, 2002 were \$26,001,000, a decrease of \$1,095,000 or 4%, from \$27,096,000 for the three months ended March 31, 2001.

Direct premiums written for the three months ended March 31, 2002 were \$20,481,000, a decrease of \$1,761,000, or 8%, from \$22,242,000 for the three months ended March 31, 2001. Voluntary direct premiums written for the three months ended March 31, 2002 were \$19,271,000, a decrease of \$2,452,000 or 11%, from \$21,723,000 for the three months ended March 31, 2001.

Voluntary personal lines direct premiums written for the three months ended March 31, 2002 were \$8,730,000, an increase of \$217,000, or 3%, from \$8,513,000 for the three months ended March 31, 2001. Private passenger automobile (PPA) direct premiums written, which represented 77% of total voluntary personal lines direct premiums written for the three months ended March 31, 2001 and 2000, increased 3% from the year earlier period. Homeowners direct premiums written for the three months ended March 31, 2002 increased 1% compared to the three months ended March 31, 2001.

Voluntary commercial lines direct premiums written for the three months ended March 31, 2002 decreased \$2,670,000, or 20%, to \$10,541,000 from \$13,211,000 for the three months ended March 31, 2001. Direct premiums written for all of the Company's commercial lines of business decreased in the three months ended March 31, 2002, compared to the three months ended March 31, 2001. This decrease in commercial lines direct premiums written was primarily attributable to a 7% decrease in commercial lines policies in force at March 31, 2002 compared to commercial lines policies in force at March 31, 2001. The reduction in commercial lines policies in force was primarily the result of a 56% decrease in commercial lines new business units in 2002 as compared to 2001.

The Company intends to continue to reduce direct written premiums in business segments that it believes can no longer provide the opportunity to earn a satisfactory return for its shareholders.

Involuntary direct premiums written, primarily PPA insurance, which comprised 6% and 2% of all direct premiums written during the three months ended March 31, 2002 and 2001, respectively, increased by \$691,000, or 133%, to \$1,209,000 in the three months ended March 31, 2002 from \$518,000 for the three months ended

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March 31, 2001, primarily due to an increase in the number of policies written by the New York Automobile Insurance Plan (NYAIP). The Company is unable to predict the volume of future assignments from the NYAIP.

Net premiums written decreased \$1,319,000, or 6%, to \$19,122,000 for the three months ended March 31, 2002 from \$20,441,000 for the three months ended March 31, 2001, primarily due to the 8% decrease in direct premiums written. Net premiums earned for the three months ended March 31, 2002 were \$23,130,000, a decrease of 1% from \$23,353,000 for the three months ended March 31, 2001.

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Net investment income was \$2,570,000 for the three months ended March 31, 2002, a decrease of 28% from \$3,563,000 for the three months ended March 31, 2001. The average pre-tax yield associated with the investment portfolio decreased 123 basis points to 5.63% for the three months ended March 31, 2002 when compared to the three months ended March 31, 2001. Average invested assets for the three months ended March 31, 2001 decreased 3% compared to the year earlier period.

Losses and loss adjustment expenses (LAE) were \$17,896,000 for the three months ended March 31, 2002, a decrease of \$865,000, or 5%, from \$18,761,000 for the three months ended March 31, 2001. The loss and LAE ratio decreased to 77.4% for the three months ended March 31, 2001 from 80.3% for the three months ended March 31, 2001, primarily due to a reduction in the loss and LAE ratio for the current accident year compared to the 2001 accident year.

The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned decreased to 34.0% for the three months ended March 31, 2002 from 34.3% for the three months ended March 31, 2001. Commissions, premium taxes and other state assessments that vary directly with the Company's premium volume represented 21.5% of net premiums earned in the three months ended March 31, 2002 compared to 22.0% in the three months ended March 31, 2001.

The Company's effective income tax rate for the three months ended March 31, 2002 was 40.8%. This rate was calculated based upon the Company's estimate of its effective income tax rate for all of 2002.

Liquidity and Capital Resources

In developing its investment strategy, the Company determines a level of cash and short-term investments which, when combined with expected cash flow, is estimated to be adequate to meet expected cash obligations. Historically, the excess of premiums collected over payments on claims, combined with cash income from investments, has provided the Company with short-term funds in excess of normal operating demands for cash. The Company's intention to continue to reduce direct premiums written in business segments where returns are unsatisfactory will likely result in continued negative cash flows from operations. The Company believes that careful management of the relationship between assets and liabilities will minimize the likelihood that investment portfolio sales will be necessary to fund insurance operations and that the effect of any such sale on the Company's stockholders' equity will not be material.

The Company's objectives with respect to its investment portfolio include maximizing total return within investment guidelines while protecting policyholders' surplus and maintaining flexibility. Like other property and casualty insurers, the Company relies on premiums as a major source of cash, and therefore liquidity. Cash flows from the Company's investment portfolio, either in the form of interest or principal payments, are an additional source of

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liquidity. Because the duration of the Company's investment portfolio relative to the duration of its liabilities is closely managed, increases or decreases in market interest rates are not expected to have a material effect on the Company's liquidity.

The Company generally designates newly acquired fixed maturity investments as available for sale and carries these investments at fair value. Unrealized gains and losses related to these investments are recorded as accumulated other comprehensive income within stockholders' equity. At March 31, 2002, the

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Company recorded as accumulated other comprehensive income in its Consolidated Balance Sheet \$1,184,000 of unrealized gains, net of taxes, associated with its investments classified as available for sale. During the three months ended March 31, 2002 the Company recorded \$628,000 of unrealized losses, net of tax, associated with its available for sale investments as other comprehensive income.

At March 31, 2002, the Company's portfolio of fixed maturity investments represented 92.3% of invested assets. Management believes that this level of bond holdings is consistent with the Company's liquidity needs because it anticipates that cash receipts from net premiums written and investment income will enable the Company to satisfy its cash obligations. Furthermore, a portion of the Company's bond portfolio is invested in mortgage-backed and other asset-backed securities which, in addition to interest income, provide monthly paydowns of bond principal.

At March 31, 2002, \$65,264,000 or 33.7%, of the Company's fixed maturity portfolio was invested in mortgage-backed and other asset-backed securities. The Company invests in a variety of collateralized mortgage obligation ("CMO") products but has not invested in the derivative type of CMO products such as interest only, principal only or inverse floating rate securities. All of the Company's CMO investments have a secondary market and their effect on the Company's liquidity does not differ from that of other fixed maturity investments.

At March 31, 2002, \$45,991,000 or 21.9% of the Company's investment portfolio was invested in fixed maturity obligations of the U.S. Government or its government sponsored agencies. Of this amount, \$33,212,000 was invested in United States Treasury Inflation Index Notes (TIPS). TIPS differ from traditional treasury securities in that in addition to regular coupon payments, the principal value changes daily based upon the Consumer Price Index (CPI) as published by the United States Department of Labor. Accretion based upon the CPI becomes part of the total return of the security and is subject to change as the CPI rises or falls. Accretion can therefore be positive or negative and is recorded as a component of net investment income. TIPS perform best in a declining interest rate environment when the referenced CPI is rising. The Company sold its entire TIPS investment in April, 2002 and recorded a gain on the sale of \$1,303,000.

At March 31, 2002 \$8,688,000, or 4.1%, of the Company's investment portfolio was invested in non-investment grade securities compared to \$9,433,000, or 4.3%, at March 31, 2001. All of the Company's non-investment grade securities are currently performing to the Company's purchase expectations.

During the three months ended March 31, 2002, the Company repurchased 114,300 shares of its common stock at an average price per share of \$21.29. The Company was holding 1,139,700 shares of its common stock in treasury at March 31, 2002.

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The Company has arranged for a \$2,000,000 unsecured credit facility from a bank in the form of a master grid note. Any borrowings under this facility are payable on demand and carry an interest rate which can be fixed or variable and is negotiated at the time of each advance. This facility is available for general working capital purposes and for repurchases of the Company's common stock. At March 31, 2002, \$600,000 was outstanding on this loan.

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As a holding company, the Company is dependent on cash dividends from MNH to meet its obligations, pay any cash dividends and repurchase its shares. MNH is subject to New Hampshire insurance laws which place certain restrictions on its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of the insurer's statutory policyholders' surplus as of the preceding December 31st. The maximum amount of dividends that MNH could pay during any twelve month period ending in 2002 without the prior approval of the New Hampshire Insurance Commissioner is \$5,263,000. MNH paid \$5,060,000 of dividends to the Company in 2001. Dividends were paid in February 2001, May 2001 and September 2001, of \$2,200,000, \$1,350,000 and \$1,510,000, respectively. MNH paid a dividend of \$2,200,000 to the Company on February 19, 2002 and as such is restricted from paying another dividend to the Company until May 2002. On May 1, 2002, the Board of Directors of MNH declared a \$900,000 cash dividend payable on May 30, 2002 to common stockholders of record on May 30, 2002. The Company declared cash dividends to its common stockholders of \$.10 per share in the first quarter of 2002 amounting to \$223,000. The Company declared a quarterly cash dividend of \$.10 per share payable on June 4, 2002 to shareholders of record as of the close of business on May 17, 2002.

Under the Management Agreement, Mutual provides employees, services and facilities for MNH to conduct its insurance business on a cost reimbursed basis. The balance in the payable to or receivable from affiliate account represents the amount owing to or owed by Mutual to the Company for the difference between premiums collected and payments made for losses, employees, services and facilities by Mutual on behalf of MNH.

Regulatory guidelines suggest that the ratio of a property-casualty insurer's annual net premiums written to its statutory surplus should not exceed 3 to 1. MNH has consistently followed a business strategy that would allow it to meet this 3 to 1 regulatory guideline. For the first three months of 2002, MNH's ratio of net premiums written to statutory surplus, annualized for a full year, was 1.5 to 1.

Relationship with Mutual

The Company's and MNH's business and day-to-day operations are closely aligned with those of Mutual. This is the result of a combination of factors. Mutual has had a historical ownership interest in the Company and MNH. Prior to November 1986 MNH was a wholly-owned subsidiary of Mutual. Following the Company's initial public offering in November 1986 and until a secondary stock offering in July 1993 the Company was a majority-owned subsidiary of Mutual. Mutual currently owns 12.1% of the Company's common stock. Under the Management Agreement, Mutual provides the Company and MNH with all facilities and with personnel to operate their business. With the exception of the Chief Operating Officer of MNH, the only officers of the Company or MNH who are paid full time employees are employees of Mutual whose services are purchased under the Management Agreement. Also, the operation of the Company's insurance business, which offers substantially the same lines of insurance as Mutual through the

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same independent insurance agents, creates a very close relationship among the companies.

During 1998, Mutual initiated discussions with the Company concerning proposals for the acquisition of the Company by Mutual. The Company determined that the terms proposed by Mutual were inadequate. The Company also determined that the Management Agreement, as currently written, creates a conflict of

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interest between the Company and Mutual in their joint operation and prevents the Company's shareholders from realizing the Company's fair value in a sale or merger. Accordingly, on July 23, 1998 the Company gave notice to Mutual of its intention to terminate the Management Agreement, and therefore, the Management Agreement will terminate on July 23, 2003 unless the parties agree to renew or extend it.

On March 4, 2002, the Company requested that Mutual extend the Management Agreement under its existing terms to December 31, 2003 in order to provide for a more orderly transition to a new management agreement with Mutual or a different manager. The Company is in discussion with various potential candidates, including Mutual, to provide management services to the Company after the current Management Agreement expires. The Company intends to base the new agreement on fee for services, rather than an allocation of expenses, as currently calculated. The Company anticipates that the future manager will be compensated for positive results through profit-sharing and that the Company will be permitted to terminate the new agreement on substantially less than the five (5) year notice that was required under the present Management Agreement.

Any agreement between MNH and Mutual or any other insurer to manage the business of MNH will require the approval of the New Hampshire Insurance Department and in the insurance department of state of the manager's domicile. State insurance departments have broad discretion to approve or disallow actions or agreements of their subject insurers in order to protect the interests of the public and policyholders, as the regulators perceive those interests to be.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market Risk

Market risk represents the potential for loss due to changes in the fair value of financial instruments. The market risk related to the Company's financial instruments primarily relates to its investment portfolio. The value of the Company's investment portfolio of \$209,674,000 at March 31, 2002 is subject to changes in interest rates and to a lesser extent on credit quality. Further, certain mortgage-backed and asset-backed securities are exposed to accelerated prepayment risk generally caused by interest rate movements. If interest rates were to decline, mortgage holders would be more likely to refinance existing mortgages at lower rates. Acceleration of future repayments could adversely affect future investment income, if reinvestment of the accelerated receipts was made in lower yielding securities.

The following table provides information related to the Company's fixed maturity investments at March 31, 2002. The table presents cash flows of principal amounts and related weighted average interest rates by expected maturity dates. The cash flows are based upon the maturity date or, in the case of mortgage-backed and asset-backed securities, expected payment patterns. Actual cash flows could differ from those shown in the table.

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Fixed Maturities

Expected Cash Flows of Principal Amounts (\$ in 000's):

| | 2002 | 2003 | 2004 | 2005 | 2006 | The |
|---|-----------|-----------|-----------|-----------|----------|-------|
| | ----- | ----- | ----- | ----- | ----- | aft |
| Held to Maturity | | | | | | |
| ----- | | | | | | |
| Mortgage & asset backed securities | \$ 2,007 | \$ 1,644 | \$ 2,602 | \$ 2,707 | \$ 1,031 | \$ |
| Average interest rate | 7.1% | 7.1% | 7.1% | 7.1% | 7.1% | |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Total | \$ 2,007 | \$ 1,644 | \$ 2,602 | \$ 2,707 | \$ 1,031 | \$ |
| | ===== | ===== | ===== | ===== | ===== | ===== |
| Available for Sale | | | | | | |
| ----- | | | | | | |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | \$ 3,496 | \$ 4,198 | \$ 0 | \$ 5,086 | \$ 0 | \$ 33 |
| Average interest rate | 6.9% | 4.1% | 0.0% | 4.2% | 0.0% | |
| Obligations of states and political subdivisions | 1,485 | 6,309 | 1,004 | 0 | 0 | |
| Average interest rate | 8.1% | 7.2% | 4.4% | 0.0% | 0.0% | |
| Corporate securities | 20,581 | 31,099 | 6,269 | 9,640 | 0 | 4 |
| Average interest rate | 7.2% | 5.3% | 6.8% | 4.1% | 0.0% | |
| Mortgage & asset backed securities | 8,543 | 23,499 | 15,322 | 797 | 2,386 | 3 |
| Average interest rate | 5.7% | 5.3% | 5.5% | 6.5% | 5.1% | |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Total | \$ 34,105 | \$ 65,105 | \$ 22,595 | \$ 15,523 | \$ 2,386 | \$ 41 |
| | ===== | ===== | ===== | ===== | ===== | ===== |

The discussion and the estimated amounts referred to above include forward-looking statements of market risk which involve certain assumptions as to market interest rates and the credit quality of the fixed maturity

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investments. Actual future market conditions may differ materially from such assumptions. Accordingly, the forward-looking statements should not be considered projections of future events by the Company.

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PART II. OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(b) Reports on Form 8-K.

No reports on Form 8-K were filed during the period for which this report is filed.

* * * * *

"Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995:

With the exception of historical information, the matters and statements discussed, made or incorporated by reference in this Quarterly Report on Form 10-Q constitute forward-looking statements and are discussed, made or incorporated by reference, as the case may be, pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward looking statements may include, without limitation, statements relating to the Company's plans, strategies, objectives, expectations and intentions. Words such as "believes," "forecasts," "intends," "possible," "expects," "anticipates," "estimates," or "plans" and similar expressions are intended to identify forward looking statements. Such forward-looking statements involve certain assumptions, risks and uncertainties that could cause actual results to differ materially from those included in or contemplated by those statements. These assumptions, risks and uncertainties include, but are not limited to, those associated with factors affecting the property-casualty insurance industry generally, including price competition, the Company's dependence on state insurance departments for approval of rate increases; size and frequency of claims, escalating damage awards, natural disasters, fluctuations in interest rates and general business conditions; the Company's dependence on investment income; the geographic concentration of the Company's business in the Northeastern United States and in particular in New York, New Hampshire, New Jersey, Rhode Island, Pennsylvania and Massachusetts; the adequacy of the Company's loss reserves; the Company's dependence on the general reinsurance market; government regulation of the insurance industry; exposure to environmental claims; dependence of the Company on its relationship with Mutual and the uncertainty concerning what will happen if the Management Agreement with Mutual is either not renewed or extended beyond its termination date of July 23, 2003; the Company's intention to reduce written premium in business segments that it believes no longer provide a satisfactory return; and the other risks and uncertainties discussed or indicated in all documents filed by the Company with the Commission. The Company expressly disclaims any obligation to update any forward-looking statements as a result of developments occurring after the date of this report.

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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.

MERCHANTS GROUP, INC.
(Registrant)

Date: May 8, 2002

By: /s/ Kenneth J. Wilson

Kenneth J. Wilson
Chief Financial Officer and
Treasurer (duly authorized
officer of the registrant and
chief accounting officer)