

**HOUSTON INTERNATIONAL INSURANCE
GROUP, LTD. AND SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS
WITH REPORT OF INDEPENDENT ACCOUNTANTS
FOR THE YEARS ENDED DECEMBER 31, 2015 AND 2014**

Report of Independent Accountants

The Board of Directors

Houston International Insurance Group, Ltd.

Report on the Financial Statements

We have audited the accompanying consolidated balance sheets of Houston International Insurance Group, Ltd. (the “Company”) as of December 31, 2015 and 2014, and the related consolidated statements of operations and comprehensive income (loss), changes in stockholders’ equity and cash flows for the years then ended and the related notes to the financial statements.

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor’s Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide our audits a reasonable basis for our opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2015 and 2014, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Ham, Langston & Brezina, L.L.P.

Houston, Texas
March 28, 2016

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.
Consolidated Balance Sheets
December 31, 2015 and 2014
(In Thousands, except for share and per share amounts)

	2015	2014
Assets		
Investments:		
Fixed maturity securities at fair value (amortized cost \$496,181 and \$481,916, respectively)	\$ 492,526	\$ 482,196
Equity securities, at fair value (cost \$45,028 and \$24,324, respectively)	42,818	24,401
Other invested assets	49,406	16,678
Short-term investments	40,473	22,887
Total investments	625,223	546,162
Cash and cash equivalents	26,508	57,896
Restricted cash	48,627	22,882
Premium receivable, net of allowance	64,290	87,529
Reinsurance recoverables	175,116	188,658
Ceded unearned premium	83,892	86,302
Deferred policy acquisition costs	39,818	28,328
Federal income taxes receivable	2,825	325
Deferred federal income taxes	17,298	17,828
Goodwill and intangible assets, net	135,326	47,124
Other assets	20,342	19,594
Total assets	\$ 1,239,265	\$ 1,102,628
Liabilities and Stockholders' Equity		
Liabilities:		
Losses and loss adjustment expenses	\$ 436,047	\$ 437,107
Unearned premiums	216,181	212,351
Deferred ceding commission	14,518	10,079
Reinsurance and premium payables	49,520	49,314
Funds held for others	44,356	31,355
Accounts payable and accrued liabilities	38,341	15,586
Notes payable	57,000	40,000
Trust debenture securities, net of debt issuance costs	58,799	58,751
Total liabilities	914,762	854,543
Commitments and Contingencies (Note 19)		
Stockholders' Equity:		
1. Common stock, par value \$0.01 per share; 170,000,000 shares authorized; 66,363,617 and 51,165,944 shares issued and 65,939,684 and 51,165,944 shares outstanding as of December 31, 2015 and 2014, respectively	664	512
2. Treasury stock, at cost, 423,933 and 0 shares as of December 31, 2015 and 2014, respectively	(4)	-
Additional paid-in capital	477,570	407,248
Stock notes receivable	(4,608)	(4,064)
Accumulated other comprehensive loss	(5,071)	(119)
Accumulated deficit	(144,048)	(155,492)
Total stockholders' equity	324,503	248,085
Total liabilities and stockholders' equity	\$ 1,239,265	\$ 1,102,628

The accompanying notes are an integral part of the financial statements

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.
Consolidated Statements of Operations and Comprehensive Income (Loss)
for the years ended December 31, 2015 and 2014
(In Thousands)

	<u>2015</u>	<u>2014</u>
Revenues:		
Premiums earned, net	\$ 326,062	\$ 302,028
Commission and fee income	8,523	1,421
Other operating income	1,401	4,356
Net investment income	9,514	3,724
Net realized gains	396	1,597
Total revenues	<u>345,896</u>	<u>313,126</u>
Expenses:		
Losses and loss adjustment expenses, net	220,794	202,751
Policy acquisition costs	43,448	39,855
Other operating expense	63,158	49,255
Interest expense	3,136	3,412
Amortization expense	1,250	957
Total expenses	<u>331,786</u>	<u>296,230</u>
Income before federal income tax expense (benefit)	14,110	16,896
Federal income tax expense (benefit)	<u>2,666</u>	<u>(2,593)</u>
Net income	<u>11,444</u>	<u>19,489</u>
Other comprehensive income (loss):		
Unrealized gains and losses on investments		
Net change in unrealized gains and losses on investments, net of tax	(4,091)	2,435
Reclassification adjustment for gains and losses on securities no longer held, net of tax	208	695
Foreign currency translation adjustment	<u>(1,069)</u>	<u>-</u>
Total other comprehensive income (loss)	<u>(4,952)</u>	<u>3,130</u>
Comprehensive income	<u>\$ 6,492</u>	<u>\$ 22,619</u>

The accompanying notes are an integral part of the financial statements

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.
Consolidated Statements of Changes in Stockholders' Equity
for the years ended December 31, 2015 and 2014
(In Thousands, Except Share Amounts and Fundraising Cost)

	<u>Common Stock</u>	<u>Treasury Stock</u>	<u>Additional Paid-in Capital</u>	<u>Stock Notes Receivable</u>	<u>Accumulated Deficit</u>	<u>Other Comprehensive Income</u>	<u>Total</u>
Balance at December 31, 2013	\$ 313	\$ (1)	\$ 320,199	\$ (2,053)	\$ (174,981)	\$ (3,249)	\$ 140,228
Issuance of common stock, net of fundraising cost of \$4 million	186	-	79,895	-	-	-	80,081
Employee share purchase	1	-	2,964	(2,011)	-	-	954
Stock-based compensation	12	-	4,190	-	-	-	4,202
Treasury stock	-	1	-	-	-	-	1
Net income	-	-	-	-	19,489	-	19,489
Other comprehensive income (loss), net of tax	-	-	-	-	-	3,130	3,130
Balance at December 31, 2014	512	-	407,248	(4,064)	(155,492)	(119)	248,085
Issuance of common stock, net of fundraising cost of \$2.5 million	144	-	67,398	-	-	-	67,542
Employee share purchase	4	(2)	1,462	(544)	-	-	920
Stock-based compensation	4	(2)	1,462	-	-	-	1,464
Net income	-	-	-	-	11,444	-	11,444
Other comprehensive income (loss), net of tax	-	-	-	-	-	(4,952)	(4,952)
Balance at December 31, 2015	<u>\$ 664</u>	<u>\$ (4)</u>	<u>\$ 477,570</u>	<u>\$ (4,608)</u>	<u>\$ (144,048)</u>	<u>\$ (5,071)</u>	<u>\$324,503</u>

The accompanying notes are an integral part of the financial statements

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.
Consolidated Statements of Cash Flows
for the years ended December 31, 2015 and 2014
(In Thousands)

	<u>2015</u>	<u>2014</u>
Operating activities:		
Net income	\$ 11,444	\$ 19,489
Adjustment to reconcile net income to net cash provided by operating activities:		
Net realized gains	(396)	(1,998)
Depreciation and amortization expense	8,197	7,366
Stock-based compensation expense	1,464	4,202
Impairment on securities	-	401
Bad debt expense	2,622	377
Equity in (income) loss on investments	(837)	2,968
Deferred income tax, net	2,877	(1,603)
Change in premiums receivable, net	21,017	(20,763)
Change in reinsurance recoverable	13,142	(35,361)
Change in ceded unearned premiums	2,410	(27,529)
Change in deferred policy acquisition costs	(11,490)	(3,368)
Change in other assets	(517)	617
Change in federal income tax receivable	(2,500)	-
Change in loss and loss adjustment expenses	(1,060)	58,598
Change in unearned premiums	3,830	15,086
Change in deferred ceding commission	4,439	6,904
Change in reinsurance and premium payables	206	6,895
Change in accounts payable and accrued liabilities	<u>14,496</u>	<u>10,819</u>
Net cash provided by operating activities	<u>69,344</u>	<u>43,100</u>
Investing activities		
Purchase investment securities	(371,696)	(340,686)
Purchase investment in affiliate	(5,734)	-
Purchase investment in partnership	(25,409)	(3,447)
Net cash paid for acquisitions	(71,840)	(1,200)
Capital expenditures	(4,136)	(4,788)
Sales and maturities of investment securities	332,813	252,491
Advance on notes receivable from related party	(270)	(1,921)
Change in short-term investments	(17,586)	23,220
Payable for securities	3,217	767
Change in restricted cash	(25,745)	(7,831)
Other	<u>192</u>	<u>(4,028)</u>
Net cash used in investing activities	<u>(186,194)</u>	<u>(87,423)</u>

The accompanying notes are an integral part of the financial statements

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.
Consolidated Statements of Cash Flows, continued
for the years ended December 31, 2015 and 2014
(In Thousands)

	<u>2015</u>	<u>2014</u>
Financing activities		
Cash from issuance of common stock	\$ 67,542	\$ 80,081
Employee share purchase	920	954
Proceeds from (repayment on) line of credit	<u>17,000</u>	<u>(20,000)</u>
Net cash provided by financing activities	<u>85,462</u>	<u>61,035</u>
Net increase (decrease) in cash and cash equivalents	(31,388)	16,712
Cash and cash equivalents at beginning of year	<u>57,896</u>	<u>41,184</u>
Cash and cash equivalents at end of year	<u>\$ 26,508</u>	<u>\$ 57,896</u>
Cash paid for interest and income taxes:		
Interest	\$ 3,121	\$ 3,411
Income taxes	\$ 2,500	\$ -
Noncash investing and financing activities:		
Business acquired with directly related liability	\$ 18,374	\$ 800

The accompanying notes are an integral part of the financial statements

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

1. Nature of Operations

Houston International Insurance Group, Ltd., (the “Company” or “HIIG”), a Delaware holding company, was organized on January 3, 2006 and is the parent company of Houston Specialty Insurance Company (“HSIC”), Oklahoma Specialty Insurance Company (“OSIC”), Imperium Insurance Company (“IIC”), Great Midwest Insurance Company (“GMIC”), HIIG Underwriting Agency, Inc. (“HIIGU”) and HIIG Service Company (“HSC”).

HSIC is a Texas-domiciled insurance company that underwrites risks primarily related to commercial property, general liability, commercial auto and inland marine as a non-admitted carrier in 49 states and on an admitted basis in Texas.

OSIC is an Oklahoma-domiciled insurance company that underwrites risks primarily related to commercial auto, commercial property and general liability as a non-admitted carrier in Texas and on an admitted basis in Oklahoma.

IIC is a Texas-domiciled insurance company that primarily underwrites direct insurance business covering risks primarily related to general liability, commercial auto, workers’ compensation and commercial property, and through general agents and managing general agents in the United States. IIC is licensed to write direct insurance and reinsurance in 50 states plus the District of Columbia.

GMIC is a Texas-domiciled insurance company that underwrites risks primarily related to general and professional liability, commercial auto, workers' compensation and property. GMIC is licensed to write direct insurance and reinsurance in 50 states plus the District of Columbia.

HIIGU, a Texas Corporation, is a managing general insurance agent for property and casualty and accident and health risks in specialty niche markets.

HSC, a Delaware Corporation, provides various administrative services to the HIIG subsidiaries.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”), and include the accounts of the Company and its subsidiaries as of and for the years ended December 31, 2015 and 2014. All inter-company transactions and balances have been eliminated in consolidation.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

2. Summary of Significant Accounting Policies, continued

Use of Estimates

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect 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 revenue and expenses during the reporting period. Actual results could differ materially from these estimates.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid short-term investments. The Company considers all short-term investments purchased with an original maturity of three months or less to be cash equivalents.

Restricted Cash

As an insurance agent, HIIGU collects premiums from its clients, and after deducting their commissions and any applicable fees, remits these premiums to insurance companies. Unremitted insurance premiums are held in a fiduciary capacity as restricted cash with the related liability reported as premium payable. The Company earns interest on these unremitted funds which is reported as investment income.

The Company also is required by state regulations to maintain assets on deposit with certain states and holds cash as collateral for certain reinsurance balances. Cash in a depository account which is held for others or restricted by a State is recorded as restricted cash.

Investments

The Company's investments in fixed maturity securities and equity securities are classified as available for sale and are reported at fair value based on quoted market prices or dealer quotes with unrealized gains and losses excluded from earnings and reported in stockholders' equity, net of taxes, as a component of accumulated other comprehensive income (loss). If quoted market prices or dealer quotes are not available, fair value is estimated based on recent trading. Premiums and discounts on mortgage-backed securities are amortized using the retroactive method adjusted for anticipated prepayments and the estimated economic life of the securities. Adjustments related to changes in prepayment assumptions are included as part of investment income.

Investment income consists of interest, dividends and equity in earnings (losses) of investees. Interest is recognized on the accrual basis, and dividends are recorded as earned at the ex-dividend date. Interest income on mortgage-backed and asset-backed securities is determined using the effective-yield method based on estimated principal repayments.

Realized gains and losses on investments are recognized in income based upon the specific identification method. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

2. Summary of Significant Accounting Policies, continued

Investments, continued

Declines in the market value of invested assets below cost are evaluated for other-than-temporary impairment losses on a quarterly basis. Impairment losses for declines in the value of fixed income and equity securities below cost attributable to issuer-specific events are based on all relevant facts and circumstances for each investment and are recognized when appropriate. For fixed income and equity securities with unrealized losses due to market conditions or industry-related events where the Company does not have the intent to sell the security and has the ability to hold the investment for a period of time sufficient to allow a market recovery or to maturity, declines in value below cost are not assumed to be other-than-temporary. When impairment of the value of an investment is considered other than temporary, the decrease in value is reported in earnings as a realized investment loss and a new cost basis is established.

The Company's other invested assets include investments in limited partnerships. The Company uses the equity method to account for investments in partnerships. Under the equity method, the initial investment is recorded at cost and is subsequently adjusted based on the Company's proportionate share of the net income or loss of the partnership.

The Company's other invested assets include investments in affiliates which represent investments in insurance agencies and managing general underwriters ("MGUs"). The Company uses the equity method to account for these investments in affiliates.

The Company's short-term investments have maturities of greater than three months and less than twelve months when purchased and are carried at fair value.

Reinsurance

In the ordinary course of business, the Company purchases facultative, excess of loss, catastrophe and quota share reinsurance. Under a reinsurance contract the assuming reinsurer is liable to the ceding company to the extent of the reinsurance. Reinsurance does not, however, discharge the Company from its primary liability to its policyholders in the event the reinsurer is unable to meet its obligations under its reinsurance agreement with the Company.

Management has evaluated its reinsurance arrangements and determined that insurance risk is transferred to the reinsurers and therefore the arrangements qualify for reinsurance accounting.

The costs of reinsurance agreements that have been determined to be short-duration prospective contracts are recognized over the life of the contract in a manner consistent with the earning of premiums on the underlying policies subject to the reinsurance contract.

Premiums earned and losses and loss adjustment expenses ("LAE") incurred are stated in the accompanying consolidated statements of operations after deduction of amounts ceded to reinsurers. Reinsurance recoverables include balances due from reinsurers on paid and unpaid losses.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

2. Summary of Significant Accounting Policies, continued

Reinsurance, continued

Balances due from reinsurers on unpaid losses, including an estimate of such recoverables related to reserves for incurred but not reported losses, are reported as assets and are included in reinsurance recoverables even though amounts due on unpaid losses and LAE are not recoverable from the reinsurer until such losses are paid. As of December 31, 2015, the Company has \$49.5 million of collateral for additional security to collect claim recoverables from various reinsurers.

Ceded premiums, losses and LAE are accounted for on a basis consistent with that used in accounting for the original policies issued and with the terms of the reinsurance agreements. Amounts recoverable are estimated in a manner consistent with the claim liability associated with the reinsured policies.

Management believes that reinsurance recoverables on unpaid losses and LAE, as recorded in the consolidated balance sheets, represent its best estimate of reinsurance recoverables on unpaid losses and LAE; however, as changes in the estimated ultimate liability for losses and LAE are determined, the estimated ultimate amount recoverable from the reinsurer will also change. Accordingly, the ultimate recoverable could be significantly more or less than the amount indicated in the consolidated financial statements. As adjustments to these estimates become necessary, such adjustments are reflected currently.

In preparing consolidated financial statements, management estimates the amounts recoverable from reinsurers to be uncollectible based on an assessment of factors, including the creditworthiness of the reinsurers and the adequacy of collateral obtained, where applicable. Uncertainties are inherent in the assessment of the creditworthiness of reinsurers and estimates of any uncollectible amounts due from reinsurers. Any change in the ability of the Company's reinsurers to meet their contractual obligations could have an impact on the consolidated financial statements and the Company's ability to meet its regulatory capital and surplus requirements. There was no allowance for uncollectible reinsurance as of December 31, 2015 and an allowance of \$0.8 million as of December 31, 2014.

Deferred Policy Acquisition Costs

Policy acquisition costs consist of commissions and premium taxes that vary with and are primarily related to the production of new or renewal business. Policy acquisition costs and related ceding commissions are deferred and charged or credited to earnings in proportion with the premium earned.

A premium deficiency is recognized if the sum of expected losses, loss adjustment expenses, unamortized acquisition costs and policy maintenance costs exceed the related unearned premiums. A premium deficiency would first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency was greater than unamortized acquisition costs, a liability would be accrued for the excess deficiency. The Company considers anticipated investment income in the determination of premium deficiencies. There were no premium deficiencies recognized during the years ended December 31, 2015 and 2014.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

2. Summary of Significant Accounting Policies, continued

Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of the assets acquired and liabilities assumed. Identifiable intangible assets with a finite useful life are amortized over the period that the asset is expected to contribute directly or indirectly to the future cash flows of the Company. Indefinite lived intangible assets are not amortized. Goodwill and identifiable intangible assets are tested for recoverability whenever events or changes in circumstances indicate that a carrying amount may not be recoverable and are subject to annual impairment testing. An impairment loss is recognized if the carrying value of an intangible asset is not recoverable and its carrying amount exceeds its fair value.

Management reviews intangible assets by first assessing qualitative factors to determine whether it is more likely than not that an intangible asset is impaired. If the more-likely-than-not threshold is met, the Company performs a quantitative impairment test by comparing the fair value with the carrying amount. The impairment test is based on a comparison of the fair value as determined by estimating the future undiscounted cash flows associated with the asset as compared to the asset's carrying value amount to determine if an impairment of such asset and its carrying value exists. The effect of any impairment would be to expense the difference between the fair value of such assets and its carrying value.

There were no impairment losses for intangibles recorded during the years ended December 31, 2015 and 2014.

Property and Equipment

Property and equipment, which is included in other assets, are recorded at cost, less accumulated depreciation. Furniture and equipment are depreciated under the straight-line method over the estimated useful lives of the respective assets, which is five to seven years. Electronic data processing equipment and software, including certain costs incurred to develop or obtain software for internal use, are capitalized and depreciated under the straight-line method over the estimated useful lives of the respective assets, which range from three to ten years.

Leasehold improvements are depreciated using the straight-line method over the shorter of the estimated useful life of the asset or the remaining original lease term, excluding options or renewal periods. Leasehold improvements are generally depreciated over approximately ten years. Expenditures for major renewals and improvements that extend the useful life of the assets are capitalized. The cost and accumulated depreciation of assets sold or otherwise disposed of are removed from the accounts and any resulting gain or loss is reflected in earnings.

Depreciation expense for the years ended December 31, 2015 and 2014 was \$4.0 and \$3.3 million, respectively.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

2. Summary of Significant Accounting Policies, continued

Losses and LAE Reserves

Losses and LAE reserves represent management's best estimate of the ultimate net cost of all reported and unreported losses that are unpaid as of the balance sheet dates. The estimated reserves for losses and LAE include the accumulation of estimates for claims reported and unpaid prior to the balance sheet dates, estimates (based on projections of relevant historical data) of claims incurred but not reported, and estimates of expenses for investigating and adjusting all incurred and unpaid claims. The reserves are estimated on an undiscounted basis, using individual case-basis valuations, statistical analyses, and various actuarial procedures. The projection of future claim payments and reporting is based on an analysis of the Company's historical experience, supplemented by analyses of industry loss data.

Amounts reported are necessarily subject to uncertainty from various sources, including changes in reporting patterns, claims settlement patterns, judicial decisions, legislation, and economic conditions and, therefore, actual loss experience may not conform to the assumptions used in determining the estimated amounts for such liability at the balance sheet dates. Management believes that, subject to the inherent variability in any such estimate, the reserves are within a reasonable and acceptable range of adequacy. Reserves are continually monitored and reviewed, and as settlements are made or reserves adjusted, the differences are reported in the current year.

Because of the nature of the business historically written, the Company's management believes that the Company has limited exposure to environmental and other toxic tort type claim liabilities.

Premiums

Property and casualty premiums are earned pro rata over the terms of the policies. Accident and health premiums are earned as billed based on census data. Premiums receivable include deferred premiums, which represent installment payments due to the Company from insureds under the payment terms of their policies.

Unearned premiums represent the portion of premiums written which is applicable to the unexpired terms of insurance policies or reinsurance contracts in force. These unearned premiums are calculated on a pro rata basis over the terms of the policies for direct and ceded amounts.

The Company establishes an allowance for bad debts ("allowance") on its premiums receivable through a charge to other expenses in the accompanying consolidated statements of operations. This allowance is determined based on estimates and assumptions to project future experience. After all collection efforts have been exhausted, the Company reduces the allowance on its premiums receivable that have been deemed uncollectible. The Company periodically reviews the adequacy of the allowance and makes adjustments as necessary.

As of December 31, 2015 and 2014, the Company has recorded an allowance for estimated uncollectible premiums receivable of approximately \$1.4 million and \$0.3 million, respectively. Future additions to the allowance may be necessary based on changes in the general economic conditions and the policyholders' financial condition.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

2. Summary of Significant Accounting Policies, continued

Fee and Commission Income

Commissions are recognized generally on the effective date of the policies or the billing date, whichever is later. In situations where the Company bills a policy or an installment prior to the effective date, deferred commission is recorded as a liability. Any subsequent premium adjustments, including policy cancellations, are recognized upon notification from the insurance carriers, or insured, as applicable. The Company records an allowance for estimated return commissions and fees that may be required to be repaid based on early termination of policies. As of December 31, 2015 and 2014, the Company determined that no allowance was required.

Income and Premium Taxes

Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due plus deferred taxes resulting from temporary differences between financial statement and income tax reporting purposes. A valuation allowance is established for any deferred tax asset not expected to be realized. As of December 31, 2015 and 2014, the Company has a valuation allowance of \$28.3 million and \$29.2 million, respectively, related to the tax benefit of net operating loss carryforwards and capital loss carryforwards.

Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The Company records a liability for uncertain tax positions where it is more likely than not that the tax position will not be sustained upon examination by the appropriate tax authority. Changes in the liability for uncertain tax positions are reflected in income tax expense in the period when a new uncertain tax position arises, judgment changes about the likelihood of uncertainty, the tax issue is settled or the statute of limitation expires. Any potential net interest income or expense and penalties related to uncertain tax positions are recorded in the consolidated statements of operations.

The Company files a consolidated federal income tax return in the United States and certain other state tax returns. The Company's admitted insurance subsidiaries pay premium taxes on gross premiums written in lieu of most state income or franchise taxes.

Stock Based Compensation

Compensation costs for share-based payments to employees, former employees and non-employee directors are recognized based on the fair value of the common stock on the grant date.

Preferred Stock

The Company has authorized 2,000,000 shares of Series A and Series B preferred stock. The preferred stock contains a provision that holders receive an annual 8% paid in kind dividend. There was no preferred stock issued or outstanding at December 31, 2015 and 2014.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

2. Summary of Significant Accounting Policies, continued

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk are primarily cash and cash equivalents, restricted cash, investments, premiums receivable and reinsurance balances.

Cash equivalents and short-term investments include investments in money market funds and securities backed by the U.S. government. Investments are diversified throughout many industries and geographic regions. The Company limits the amount of credit exposure with any one financial institution and believes that no significant concentration of credit risk exists with respect to cash and investments. At December 31, 2015 and 2014, the outstanding premiums receivable are generally diversified due to the large number of entities comprising the Company's customer base and their dispersion across many different lines of business and geographic regions. Failure by general agents to remit premiums could result in premium write-offs and a corresponding loss of income by the Company. The Company also has recoverables from its reinsurers. One reinsurer comprises approximately 20% of the reinsurance recoverables balance and is rated A+ by A.M. Best Company, a widely recognized rating agency with an exclusive insurance industry focus. Reinsurance contracts do not relieve the Company from its obligations to claimants or policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company. The Company evaluates the financial condition of its reinsurers and may obtain collateral to minimize its exposure to significant losses from reinsurer insolvencies. The Company reinsures with highly rated companies and, as such, limits its credit risk.

Reclassification

Certain 2014 amounts have been reclassified to conform to the 2015 presentation. Such reclassifications had no effect on the Company's financial position, net income or cash flows.

3. Recent Accounting Pronouncements

The Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-02, *Leases*, to improve the financial reporting of leasing transactions. Under current guidance for lessees, leases are only included on the balance sheet if certain criteria, classifying the agreement as a capital lease, are met. This update will require the recognition of a right-of-use asset and a corresponding lease liability, discounted to the present value, for all leases that extend beyond 12 months. For operating leases, the asset and liability will be expensed over the lease term on a straight-line basis, with all cash flows included in the operating section of the statement of cash flows. For finance leases, interest on the lease liability will be recognized separately from the amortization of the right-of-use asset in the statement of comprehensive income and the repayment of the principal portion of the lease liability will be classified as a financing activity while the interest component will be included in the operating section of the statement of cash flows.

This ASU is effective for reporting periods beginning after December 15, 2018. Early adoption is permitted. Upon adoption, leases will be recognized and measured at the beginning of the earliest period presented using a modified retrospective approach. The Company has not yet completed its analysis of the effect that adopting this ASU will have on its financial statements.

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Notes to Consolidated Financial Statements

3. Recent Accounting Pronouncements, continued

ASU 2016-01, Financial Instruments - Overall: Recognition and Measurement of Financial Assets and Financial Liabilities was issued to improve the recognition and measurement of financial instruments. The new guidance makes targeted improvements to GAAP as follows:

- a. Requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income;
- b. Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment;
- c. Requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments;
- d. Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; and
- e. Clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

This ASU is effective for reporting periods beginning after December 15, 2018. Early adoption is only permitted for provision (e) above. Upon adoption, a cumulative-effect adjustment to the balance sheet will be made as of the beginning of the fiscal year of adoption. The Company has not yet completed the analysis of the effect that adopting this ASU will have on its consolidated financial statements.

ASU 2015-09, Financial Services-Insurance: Disclosures about Short-Duration Contracts was issued to enhance disclosures about an entity's insurance liabilities, including the nature, amount, timing and uncertainty of cash flows related to those liabilities. The new guidance requires the following information related to unpaid losses and loss adjustment expenses be disclosed using an appropriate level of disaggregation so as not to obscure useful information:

- a. Net incurred and paid loss development information by accident year for the number of years for which losses incurred typically remain outstanding, but need not to exceed 10 years;
- b. A reconciliation of incurred and paid loss development information to the aggregate carrying amount of the liability for unpaid losses and loss adjustment expenses, with separate disclosure of reinsurance recoverable on unpaid losses for each period presented in the statement of financial position;

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

3. Recent Accounting Pronouncements, continued

- c. For each accident year presented, the total of incurred but not reported liabilities plus expected development on reported losses included in the liability for unpaid losses and loss adjustment expenses;
- d. For each accident year presented, quantitative information about loss frequency accompanied by a qualitative description of methodologies used for determining loss frequency information; and
- e. For all losses, the average annual percentage payout of incurred losses by age.

This ASU is effective for annual reporting periods beginning after December 15, 2016. Early adoption is permitted. The Company did not early adopt this ASU and, while disclosures will be increased, the Company does not believe the adoption will have a material effect on its consolidated financial statements.

ASU 2015-03, Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs was issued to simplify the presentation of debt issuance costs by requiring them to be presented on the balance sheet as a direct deduction from the carrying amount of the related recognized debt liability, consistent with debt discounts. This ASU is effective for annual reporting periods beginning after December 15, 2015. Early adoption is permitted. The Company has early-adopted this ASU, which resulted in a reclassification as of December 31, 2014 of approximately \$1 million of debt issuance costs, previously included in intangible assets, as a direct reduction of the trust debenture security.

ASU 2014-09, Revenue from Contracts with Customer was issued to specify the accounting for revenue from contracts with customers. The new ASU requires that an entity recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled. While insurance contracts are excluded from this ASU, fee income related to any brokerage operations will be subject to this updated guidance. ASU 2014-09 is effective for interim and annual periods beginning after December 15, 2017 and is not expected to have a significant impact on the Company's consolidated financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

4. Goodwill

The changes in the carrying amount of goodwill for the years ended December 31, 2015 and 2014 are as follows (in thousands):

	<u>2015</u>	<u>2014</u>
Balance as of January 1	\$ 24,444	\$ 22,557
Goodwill acquired during the year:		
Compass	-	1,887
Elite	74,416	-
CRU	<u>11,809</u>	<u>-</u>
Balance as of December 31	<u>\$ 110,669</u>	<u>\$ 24,444</u>

5. Intangibles

The following details the Company's acquired identifiable intangible assets as of December 31, 2015 and 2014 (in thousands):

	<u>2015</u>		<u>2014</u>	
	<u>Gross Value</u>	<u>Accumulated</u>	<u>Gross Value</u>	<u>Accumulated</u>
	<u>Assigned</u>	<u>Amortization</u>	<u>Assigned</u>	<u>Amortization</u>
Amortizing intangible assets:				
Policy renewals	\$ 3,826	\$ (2,231)	\$ 1,987	\$ (1,987)
Managing general agents' relationships (MGA)	12,696	(6,377)	12,696	(5,671)
Noncompete/exclusivity agreements	4,829	(3,227)	3,933	(2,975)
Favorable lease	<u>567</u>	<u>(567)</u>	<u>567</u>	<u>(567)</u>
Total amortizing intangible assets	<u>21,918</u>	<u>\$ (12,402)</u>	<u>19,183</u>	<u>\$ (11,200)</u>
Non-amortizing intangible assets:				
Trademarks	1,122		678	
Regulatory insurance licenses	<u>14,019</u>		<u>14,019</u>	
Total non-amortizing intangible assets	<u>15,141</u>		<u>14,697</u>	
Total gross intangible assets	<u>\$ 37,059</u>		<u>\$ 33,880</u>	

The intangible assets related to policy renewals, MGA relationships and noncompete/exclusivity agreements have a weighted average useful life of ten years.

Amortization expense for the year ended December 31, 2015 and 2014 was approximately \$1.3 million and \$1.0 million, respectively.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

5. Intangibles, continued

Estimated future net amortization expense for the next five years is as follows (in thousands):

<u>Year</u>	
2016	\$ 1,462
2017	1,462
2018	1,462
2019	1,462
2020	1,122

6. Investments

The amortized cost and the fair value of the Company's investments are summarized as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
	<i>(In Thousands)</i>			
December 31, 2015				
Fixed maturity securities:				
U.S. government securities	\$ 58,144	\$ 126	\$ (119)	\$ 58,151
Federal agency securities	5,000	-	(8)	4,992
Corporate securities and miscellaneous	184,297	166	(3,071)	181,392
Municipal securities	71,956	898	(414)	72,440
Residential mortgage-backed securities	72,357	252	(878)	71,731
Commercial mortgage-backed securities	26,214	67	(299)	25,982
Asset-backed securities	<u>78,213</u>	<u>6</u>	<u>(381)</u>	<u>77,838</u>
Total fixed maturity securities	<u>\$ 496,181</u>	<u>\$ 1,515</u>	<u>\$ (5,170)</u>	<u>\$ 492,526</u>
Equity securities:				
Common stocks	\$ 41,767	\$ 2,038	\$ (4,117)	\$ 39,688
Mutual funds	<u>3,261</u>	<u>6</u>	<u>(137)</u>	<u>3,130</u>
Total equity securities	<u>\$ 45,028</u>	<u>\$ 2,044</u>	<u>\$ (4,254)</u>	<u>\$ 42,818</u>

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

6. Investments, continued

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
	<i>(In Thousands)</i>			
December 31, 2014				
Fixed maturity securities:				
U.S. government securities	\$ 75,304	\$ 112	\$ (121)	\$ 75,295
Federal agency securities	16,129	180	(4)	16,305
Corporate securities and miscellaneous	174,862	404	(693)	174,573
Municipal securities	41,556	648	(133)	42,071
Residential mortgage-backed securities	80,077	433	(621)	79,889
Commercial mortgage-backed securities	31,091	253	(76)	31,268
Asset-backed securities	<u>62,897</u>	<u>27</u>	<u>(129)</u>	<u>62,795</u>
Total fixed maturity securities	<u>\$ 481,916</u>	<u>\$ 2,057</u>	<u>\$ (1,777)</u>	<u>\$ 482,196</u>
Equity securities:				
Common stocks	<u>\$ 24,324</u>	<u>\$ 1,120</u>	<u>\$ (1,043)</u>	<u>\$ 24,401</u>
Total equity securities	<u>\$ 24,324</u>	<u>\$ 1,120</u>	<u>\$ (1,043)</u>	<u>\$ 24,401</u>

The amortized cost and estimated fair value of fixed maturity investments at December 31, 2015 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Also, changing interest rates, tax considerations or other factors may result in portfolio sales prior to maturity.

	<u>Amortized Cost</u>	<u>Fair Value</u>
	<i>(In Thousands)</i>	
Due less than one year	\$ 51,326	\$ 51,248
Due after one year through five years	165,619	165,133
Due after five years through ten years	65,652	63,613
Due after ten years	36,800	36,981
Residential mortgage-backed securities	72,357	71,731
Commercial mortgage-backed securities	26,214	25,982
Asset-backed securities	<u>78,213</u>	<u>77,838</u>
Total	<u>\$ 496,181</u>	<u>\$ 492,526</u>

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

6. Investments, continued

For fixed maturity investments, the Company is required to recognize an other than temporary impairment (“OTTI”) loss when it concludes it has the intent to sell or it is more likely than not it will be required to sell an impaired fixed maturity before the security recovers to its amortized cost value or it is likely it will not recover the entire amortized cost value of an impaired fixed maturity security. If the Company has the intent to sell or it is more likely than not that the Company will be required to sell an impaired fixed maturity investment before the security recovers to its amortized cost value, the security is written down to fair value and the entire amount of the write-down is included in net income as a realized investment loss. For all other impaired fixed maturities, the impairment loss is separated into the amount representing the credit loss and the amount representing the loss related to all other factors. The amount of the impairment loss that represents the credit loss is included in net income as a realized investment loss and the amount of the impairment loss that relates to all other factors is included in other comprehensive income.

For equity securities, the Company considers its intent and ability to hold a security for a period of time sufficient to allow for the recovery of cost. If the decline in the fair value of an equity security is deemed to be other than temporary, the security is written down to fair value and the amount of the write down is included in net income as an other than temporary impairment loss. An OTTI adjustment of \$0 million and \$0.4 million was made on equity securities considered impaired and recorded as realized losses for the years ended December 31, 2015 and 2014, respectively.

For fixed maturities, the split between the amount of OTTI losses that represents credit losses and the amount that relates to all other factors is principally based on assumptions regarding the amount and timing of projected cash flows. For fixed maturities other than mortgage-backed securities, cash flow estimates are based on assumptions regarding the probability of default and estimates regarding the timing and amount of recoveries associated with a default. For mortgage-backed securities, cash flow estimates are based on assumptions regarding future prepayment rates, default rates, loss severity and timing of recoveries. The Company has developed the estimates of projected cash flows using information based on historical market data, industry analyst reports and forecasts and other data relevant to the collectability of a security.

The following tables summarize gross unrealized losses and the corresponding fair values of investments, aggregated by length of time that individual securities have been in a continuous unrealized loss position.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

6. Investments, continued

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>
	<i>(In Thousands)</i>					
December 31, 2015						
U.S. government securities	\$ 41,030	\$ (119)	\$ -	\$ -	\$ 41,030	\$ (119)
Federal agency securities	4,992	(8)	-	-	4,992	(8)
Corporate securities and miscellaneous	130,417	(2,832)	17,791	(239)	148,208	(3,071)
Municipal securities	20,027	(346)	1,657	(68)	21,684	(414)
Residential mortgage-backed securities	29,715	(588)	10,698	(290)	40,413	(878)
Commercial mortgage-backed securities	15,918	(288)	556	(11)	16,474	(299)
Asset-backed securities	71,390	(341)	3,752	(40)	75,142	(381)
Total fixed maturity securities	\$ 313,489	\$ (4,522)	\$ 34,454	\$ (648)	\$ 347,943	\$ (5,170)
Equity securities	\$ 21,659	\$ (2,946)	\$ 3,008	\$ (1,308)	\$ 24,667	\$ (4,254)
Total	\$ 335,148	\$ (7,468)	\$ 37,462	\$ (1,956)	\$ 372,610	\$ (9,424)

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>
	<i>(In Thousands)</i>					
December 31, 2014						
U.S. government securities	\$ 40,129	\$ (41)	\$ 7,161	\$ (80)	\$ 47,290	\$ (121)
Federal agency securities	4,998	(2)	179	(2)	5,177	(4)
Corporate securities and miscellaneous	82,430	(237)	19,213	(456)	101,643	(693)
Municipal securities	5,796	(31)	6,647	(102)	12,443	(133)
Residential mortgage-backed securities	799	(6)	41,553	(615)	42,352	(621)
Commercial mortgage-backed securities	11,202	(34)	4,046	(42)	15,248	(76)
Asset-backed securities	48,655	(128)	2,099	(1)	50,754	(129)
Total fixed maturity securities	\$ 194,009	\$ (479)	\$ 80,898	\$ (1,298)	\$ 274,907	\$ (1,777)
Equity securities	\$ 12,887	\$ (1,043)	\$ -	\$ -	\$ 12,887	\$ (1,043)
Total	\$ 206,896	\$ (1,522)	\$ 80,898	\$ (1,298)	\$ 287,794	\$ (2,820)

At December 31, 2015, 313 individual fixed maturity and equity securities were in a gross unrealized loss position, of which 255 were fixed maturities. The Company does not have the intent to sell and it is not more likely than not that the Company will be required to sell these fixed maturities before the securities recover to their amortized cost value. In addition, the Company believes that none of the declines in the fair values of these fixed maturities relate to credit losses. The Company has the intent and ability to hold the equity securities in an unrealized loss position for a period of time sufficient to allow for the recovery of cost. The Company believes that none of the declines in the fair value of these fixed maturities and equity securities were other than temporary at December 31, 2015.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

6. Investments, continued

The components of net realized gains for the years ended December 31, 2015 and 2014 are as follows (in thousands):

	2015	2014
Gross realized gains		
Fixed maturity securities	\$ 188	\$ 95
Equity securities	634	2,723
Other	351	-
Total	1,173	2,818
Gross realized losses		
Fixed maturity securities	(130)	(28)
Equity securities	(647)	(393)
Sale of business – indemnification claim	-	(399)
Other than temporary impairment	-	(401)
Total	(777)	(1,221)
Net realized gains	\$ 396	\$ 1,597

Proceeds from sales and maturities of fixed maturity securities and equity securities for the year ended December 31, 2015 were approximately \$314.4 million and \$18.4 million, respectively. Proceeds from sales and maturities of fixed maturity securities and equity securities for the year ended December 31, 2014 were approximately \$225.4 million and \$27.1 million, respectively.

The Company's net investment income for the year ended December 31, 2015 and 2014 is summarized as follows (in thousands):

	2015	2014
Income:		
Fixed maturity securities	\$ 8,690	\$ 6,723
Equity securities	735	506
Investment in affiliate	997	(3,088)
Short-term investments and cash	25	56
Other	202	309
Total investment income	10,649	4,506
Investment expenses	(1,135)	(782)
Net investment income	\$ 9,514	\$ 3,724

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

6. Investments, continued

The change in net unrealized gains (losses) on investments, net of deferred income taxes, for the years ended December 31, 2015 and 2014 is as follows (in thousands):

	<u>2015</u>	<u>2014</u>
Fixed maturity securities	\$ (3,935)	\$ 4,928
Equity securities	(2,287)	(1,168)
Foreign currency translation	(1,069)	-
Deferred income taxes	<u>2,339</u>	<u>(630)</u>
Total	<u>\$ (4,952)</u>	<u>\$ 3,130</u>

The Company is required by various state regulations to maintain cash, securities or letters of credit on deposit with the states in a depository account. At December 31, 2015 and 2014, cash and securities having a fair value of approximately \$63.4 million and \$82.4 million, respectively, were on deposit.

7. Other Invested Assets

Investment in Affiliates

As a result of the sale of Southwest Risk, LP (“SWR”), in December 2010, the Company reinvested \$5.0 million of its proceeds for an approximate 15% ownership of ClearView Risk Holdings, LLC (“CVR”), the acquirer of SWR. As a repayment of a note receivable and as part of a recovery associated with an indemnification claim related to the SWR transaction, the Company received, from a related party, an additional 400,000 shares of CVR in 2013. The shares were recorded at fair value at the date of the agreement. As a result, the Company’s ownership in CVR increased from 15% to approximately 26%. In 2015, as part of a CVR capital raise, the Company invested an additional \$1.2 million, which resulted in a decrease in the Company’s ownership in CVR to approximately 25%. During the years ended December 31, 2015 and 2014, the Company recorded equity in income (losses) of approximately \$0.3 million and \$(3.1) million, respectively, from its investment in CVR which represented its pro rata share of CVR’s net income (loss) for the years ended December 31, 2015 and 2014.

In March 2015, the Company purchased a 20% ownership in Regional Insurance Services Company LLC and its affiliates (“RISCOM”). The initial purchase price was \$3.2 million in cash. The purchase agreement includes a contingency for future earnout payments up to \$1.0 million. The Company recorded equity in income of approximately \$0.5 million from its investment in RISCOM, which represented its pro rata share of RISCOM’s net income for the year ended December 31, 2015.

Immediately after the close of the transaction discussed above, RISCOM purchased 203,049 shares of the Company through the Westaim HIIG LP for \$1.0 million in cash.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

7. Other Invested Assets, continued

Investment in Affiliates, continued

During 2014, the Company entered into a convertible note agreement with PVI Agency, LLC, an insurance agency, (the “Borrower”) for \$1.5 million. The note bears interest at 3% per annum and interest was due annually commencing January 1, 2015.

In December 2015, the Company acquired a 24.5% capital interest in PVI Agency, LLC by converting the \$1.5 million note receivable to equity and investing an additional \$1.0 million of cash. There was no equity in income recorded for this investment in 2015.

Investment in Partnerships

During 2015 and 2014, the Company invested \$0.4 million and \$3.4 million, respectively, in Dowling Capital Partners I, a limited partnership (“DCP”), as part of a total investment commitment of \$10.0 million. The Company’s investment represents approximately 6% interest in DCP.

During 2015, the Company invested \$25.0 million in Arena Special Opportunities Fund, LP (“Arena”), which is affiliated with Westaim Corporation (“Westaim”) who, through the Westaim HIIG Limited Partnership, (“Westaim HIIG LP”) is the controlling shareholder of the Company. No income was recorded in 2015 related to this investment.

8. Trust Debenture Securities

On August 2, 2006, Delos Capital Trust (the Trust), a Delaware statutory trust, issued \$58.0 million of fixed/floating rate capital securities guaranteed by the Company. The Trust issued \$1.8 million of common stock to the Company.

The sole asset of the Trust consists of Fixed/Floating Rate Junior Subordinated Deferrable Interest Debentures (the Debentures) with a principal amount of \$59.8 million issued by the Company. The Debentures are redeemable on or after September 15, 2011 and have a maturity date of September 15, 2036. The Debentures are unsecured obligations of the Company. Interest on the Debentures is payable quarterly at an annual rate based on the three month LIBOR plus 3.4%, which was 3.91% at December 31, 2015.

The Company has not consolidated the Trust, which issued the capital securities, as it did not meet the consolidation requirements under guidance issued by FASB. The Company reflected the debt related to the trust debenture securities in the December 31, 2015 and 2014 consolidated balance sheet, net of debt issuance costs of approximately \$1.0 million.

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Notes to Consolidated Financial Statements

9. Notes Payable

Term Loan Note and Revolving Line of Credit

On April 30, 2014, a financial institution and the Company executed a new five-year term loan note in the principal amount of \$40 million due May 1, 2019, and a new, related credit agreement. The previous term notes and credit agreement terminated thus negating the defaults under the old notes and credit agreement. The interest rate on the note is one month LIBOR (0.243% at December 31, 2015) plus the Eurodollar Rate, which is defined as 1.75%, or the Highest Lawful Rate, whichever is less. The Company, at its option and no more than once per month, may elect whether all of the term loan's interest will accrue at either the Eurodollar Rate or Prime Rate. Prime Rate is defined as a per annum rate of interest as published in the "Money Rates" column of the Wall Street Journal or if not available, the rate established by the financial institution as its Prime Rate. Interest only payments are due and payable on a quarterly basis through May 1, 2019. The term loan is collateralized by a perfected first priority security interest in all of the assets of HIIG and HIIGU and the outstanding capital stock of HSIC. In addition, the Company executed a new revolving promissory note in the principal amount of \$25 million due May 1, 2016. The interest rate on the note is one month LIBOR (0.243% at December 31, 2015) plus the Eurodollar Rate, which is defined as 1.75%, or the Highest Lawful Rate, whichever is less. In addition, there is a usage fee of 0.20% on the unused portion of the revolving promissory note. Interest only payments are due and payable on a quarterly basis through May 1, 2016. The outstanding balance on the revolving promissory note was \$17 million and \$0 million as of December 31, 2015 and 2014, respectively.

10. Funds at Lloyds

The Company has \$1.0 million of Funds at Lloyds that it uses to guarantee performance on a 2012 and 2013 reinsurance contract. The reinsurance contract expired in 2014.

11. Income Taxes

The Federal income tax expense (benefit) consists of the following for the years ended December 31, 2015 and 2014 (in thousands):

	<u>2015</u>	<u>2014</u>
Current tax expense (benefit)	\$ (211)	\$ (990)
Deferred tax expense (benefit) related to:		
Future tax deductions	3,727	5,138
Valuation allowance change	<u>(850)</u>	<u>(6,741)</u>
Total income tax expense (benefit)	<u>\$ 2,666</u>	<u>\$ (2,593)</u>

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

11. Income Taxes, continued

The differences between income taxes expected at the Federal statutory income tax rate of 35% and the reported income tax expense in 2015 and 2014 are summarized as follows (in thousands):

	<u>2015</u>		<u>2014</u>	
Income tax expense at federal statutory rate	\$ 4,938	35.0%	\$ 5,913	35.0%
Prior year true ups	(973)	(6.9)%	(1,811)	(10.7)%
Change in valuation allowance	(850)	(6.0)%	(6,741)	(39.9)%
Purchase price earn out revaluation	(404)	(2.9)%	-	0.0%
Tax advantaged investments	(182)	(1.3)%	(138)	(1.0)%
Other	137	1.0%	184	1.1%
Total income tax expense (benefit)	<u>\$ 2,666</u>	<u>18.9%</u>	<u>\$ (2,593)</u>	<u>(15.5)%</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below (in thousands):

	<u>2015</u>	<u>2014</u>
Deferred tax assets:		
Net operating losses	\$ 32,022	\$ 30,925
Losses and loss adjustment expenses	8,316	8,980
Unearned premiums	9,295	8,832
Goodwill	-	870
Stock options/awards	1,724	1,257
AMT credits	1,069	1,106
Impairments	2,243	2,254
Indemnity settlement	175	1,250
Unrealized losses on investments	2,436	89
Other	<u>5,036</u>	<u>4,566</u>
Total deferred tax assets before valuation allowance	62,316	60,129
Valuation allowance	<u>(28,343)</u>	<u>(29,193)</u>
Total deferred tax assets	<u>\$ 33,973</u>	<u>\$ 30,936</u>
Deferred tax liabilities:		
Deferred policy acquisition costs	\$ 8,830	\$ 6,362
Intangibles	2,896	2,896
Discount on fixed maturity securities	145	132
Depreciation	1,624	991
Other	<u>3,180</u>	<u>2,727</u>
Total deferred tax liabilities	<u>16,675</u>	<u>13,108</u>
Net deferred tax asset	<u>\$ 17,298</u>	<u>\$ 17,828</u>

The Company paid \$2.5 million and \$0 million of income taxes, for the years ended December 31, 2015 and 2014, respectively, that are available for recoupment in the event of future losses.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

11. Income Taxes, continued

As of December 31, 2015, there were no material positions for which management believes it is more likely than not that, the total amounts will significantly increase or decrease within 12 months of the reporting date. The Company classifies all interest and penalties related to tax contingencies as income tax expense. As of December 31, 2015 and 2014, no accrued interest was recorded as an income tax liability. Tax years 2012 through 2015 are open under the statute of limitations and remain subject to examination by the IRS.

Management currently provides a valuation allowance against deferred tax assets when it is more likely than not that some portion, or all, of deferred tax assets will not be realized.

The change in the Company's valuation allowance for the years ended December 31, 2015 and 2014 is as follows (in thousands):

	<u>2015</u>	<u>2014</u>
Balance at January 1	\$ 29,193	\$ 36,442
Utilization of net operating losses carried forward	(4,610)	(2,419)
Increase (decrease) related to capital loss	<u>3,760</u>	<u>(4,830)</u>
Balance at December 31	<u>\$ 28,343</u>	<u>\$ 29,193</u>

Management has determined that the valuation allowance of \$24.5 million is required for a portion of the tax affected net operating loss carryforward. Management has also determined that a valuation allowance of \$3.8 million is required for deferred tax assets, which are classified as capital losses for tax purposes.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

12. Losses and Loss Adjustment Expenses

A reconciliation of unpaid losses and loss adjustment expenses as reported in the consolidated balance sheets as of December 31, 2015 and 2014 and the consolidated statements of operations for the years ended December 31, 2015 and 2014 are as follows (in thousands):

	2015	2014
Reserves for losses and LAE, beginning of year	\$ 437,107	\$ 378,509
Less reinsurance recoverables	<u>(156,448)</u>	<u>(139,023)</u>
Reserves for losses and LAE, beginning of year, net of reinsurance	<u>280,659</u>	<u>239,486</u>
Incurred, net of reinsurance, related to:		
Current year	200,051	177,305
Prior years	<u>20,743</u>	<u>25,446</u>
Total incurred, net of reinsurance	<u>220,794</u>	<u>202,751</u>
Paid, net of reinsurance, related to:		
Current year	66,942	47,423
Prior years	<u>138,606</u>	<u>114,155</u>
Total paid	<u>205,548</u>	<u>161,578</u>
Net reserves for losses and LAE at end of year	295,905	280,659
Plus reinsurance recoverables	<u>140,142</u>	<u>156,448</u>
Reserves for losses and LAE at end of year	<u>\$ 436,047</u>	<u>\$ 437,107</u>

Estimates of incurred losses and LAE attributable to insured events of prior years' reflects adverse development of approximately \$20.7 million and \$25.4 million for the years ended December 31, 2015 and 2014, respectively. The adverse development in 2015 and 2014 primarily relates to certain cancelled workers' compensation and other liability program business, which is in run off, as a result of higher than expected loss payments on this run off business. The Company also reviewed the case reserves in 2015 and 2014 that have developed adversely and other potentially volatile programs and increased its reserves to reflect the effect of the higher than anticipated claims settlement on its remaining reserves related to this business. The open claim count related to all run off programs continues to reduce significantly and the Company is diligently pursuing settling these claims as quickly as possible.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

13. Premiums

Direct premiums written by line of business for the years ended December 31, 2015 and 2014 are as follows (in thousands):

	<u>2015</u>	<u>2014</u>
Other liability occurrence	26.3%	28.4%
Commercial auto liability	14.5	16.5
Workers' compensation	13.8	16.4
Property	21.6	21.0
Auto physical damage	3.8	4.4
Accident and health	2.7	-
Other	<u>17.3</u>	<u>13.3</u>
Total	<u>100.0%</u>	<u>100.0%</u>

For the years ended December 31, 2015 and 2014, the Company's direct premiums written were produced from the following states:

	<u>2015</u>	<u>2014</u>
Texas	32.3%	29.6%
Louisiana	11.0	12.7
California	6.1	6.8
Florida	6.2	6.0
Oklahoma	4.9	5.0
West Virginia	2.7	2.9
Illinois	2.8	2.6
Pennsylvania	3.0	2.6
New York	3.1	2.5
Kentucky	3.0	2.5
All other states	<u>24.9</u>	<u>26.8</u>
Total	<u>100.0%</u>	<u>100.0%</u>

14. Reinsurance

Certain premiums and benefits are assumed from and ceded to other insurance companies under various reinsurance agreements. The ceded reinsurance agreements provide the Company with increased capacity to write larger risks and maintain its exposure to loss within its capital resources. The Company remains obligated for amounts ceded in the event that the reinsurers do not meet their obligations.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

14. Reinsurance, continued

The effects of reinsurance on premiums written and earned for the years ended December 31, 2015 and 2014 are as follows:

	<u>2015</u>		<u>2014</u>	
	<u>Written</u>	<u>Earned</u>	<u>Written</u>	<u>Earned</u>
Direct premiums	\$ 424,616	\$ 422,674	\$ 394,088	\$ 365,991
Assumed premiums	84,100	82,211	50,081	62,635
Ceded premiums	<u>(176,415)</u>	<u>(178,823)</u>	<u>(154,455)</u>	<u>(126,598)</u>
Net premiums	<u>\$ 332,301</u>	<u>\$ 326,062</u>	<u>\$ 289,714</u>	<u>\$ 302,028</u>
Ceded losses and LAE incurred		<u>\$ 119,009</u>		<u>\$ 142,632</u>

Reinsurance recoverables on unpaid losses and loss adjustment expense reserves ceded at December 31, 2015 and 2014 were approximately \$140.1 million and \$156.4 million, respectively. Reinsurance recoverables on paid losses and loss adjustment expense ceded at December 31, 2015 and 2014 were approximately \$35.0 million and \$32.3 million, respectively. Ceded unearned premiums at December 31, 2015 and 2014 were approximately \$83.9 million and \$86.3 million, respectively.

The Company entered into agreements with one of its reinsurers, whereby the reinsurer voluntarily established funded trust accounts with the Company as the sole beneficiary. These trust accounts provide the Company additional security to collect claim recoverables under reinsurance contracts. At December 31, 2015, the market value of these accounts was approximately \$16.9 million representing case and incurred but not recorded loss reserves. The agreement provides that, as was customary in the past, the reinsurer will continue claim payment reimbursements without disturbing the trust balances. The trust amount will be adjusted periodically, by mutual agreement, based on the current activities of loss reserve recoverables.

15. Profit Commissions

The Company has entered into contractual agreements with program managers and reinsurers that transfer a limited amount of a program's profits or losses through contingent commissions. During the years ended December 31, 2015 and 2014, receivables related to profit sharing commissions with program managers and reinsurers amounted to approximately \$0.8 million and \$1.6 million, respectively.

Additional or return commissions or other equivalent amounts pursuant to contractual agreements with program managers and reinsurers of a profit sharing nature are accrued based on the experience of the underlying business, using case and statistical methods. The Company recorded approximately \$1.5 million and \$0 million of income (expenses) related to profit sharing commissions on its ceded book of business during the years ended December 31, 2015 and 2014, respectively.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

16. Stock-based Compensation

The Company has two inactive stock-based compensation plans, the 2006 Stock Option and Incentive Plan (the 2006 Plan) and the 2009 Incentive Stock Option Plan (the 2009 Plan). There are currently no outstanding options or shares under the 2006 Plan or the 2009 Plan. The Company has a third plan, the Employee Share Program (the 2011 Program), to incentivize its employees. The Plan and Program are administered by the Compensation Committee of the Board of Directors.

The 2011 Program allows key employees to purchase the Company's common stock at a price based on the book value of the Company at the end of the quarter granted which approximates fair value. The Company then matches all purchases with stock grants. The grants vest as the employee makes cash payments for the purchase of common stock over a period of up to nine years. Key employees purchased 404,617 shares and 652,605 shares of the Company's common stock during the years ended December 31, 2015 and 2014, respectively. In accordance with the plan, the Company granted a match of 404,617 and 652,605 shares of its common stock, of which 121,385 shares and 210,079 shares had vested as of December 31, 2015 and 2014, respectively. Included in the statement of stockholders' equity is \$4.6 million and \$4.1 million of stock notes receivables at December 31, 2015 and 2014, respectively, from employees related to their purchase of common stock. The receivables bear interest ranging from .95% to 2% per year. Interest is due quarterly.

During the years ended December 31, 2015 and 2014, the Company recorded \$1.5 million and \$4.2 million, respectively, of stock based compensation related to share grants under the 2011 Program. The total tax benefit recognized in earnings from stock-based compensation arrangements was \$0.5 million and \$1.5 million during the years ended December 31, 2015 and 2014, respectively.

A summary of the status of the Company's non-vested restricted common stock awards as of December 31, 2015 and 2014, and changes during the years ended December 31, 2015 and 2014, is presented below:

	<u>2015</u>	<u>2014</u>
Non-vested at beginning of period	633,882	218,892
Granted	404,617	652,605
Vested	(160,829)	(218,221)
Forfeited	<u>(152,488)</u>	<u>(19,394)</u>
Non-vested at end of period	<u>725,182</u>	<u>633,882</u>

17. Employee Benefit Plans

The HIIG 401(k) Plan (the Plan) is a multi-employer profit sharing plan. The Plan is subject to provisions of the Employee Retirement Income Security Act of 1974. The Plan is available to substantially all employees. Contributions are matched on a discretionary basis with Board of Directors' approval. The Company accrued \$0.7 and \$0.6 million of matching contributions as of December 31, 2015 and 2014, respectively.

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Notes to Consolidated Financial Statements

18. Change in Control and Related Party Transactions

In 2014 the Company and Westaim HIIG LP, a limited partnership controlled by Westaim, a Canadian public company, executed a subscription agreement as part of a two-step transaction whereby Westaim HIIG LP acquired an approximate 54% controlling interest in the Company that Lightyear Fund II, L.P. (“Lightyear”) and a group of other investors owned.

In addition, in accordance with the subscription agreement, Westaim HIIG LP invested \$60.0 million in cash into the Company in exchange for newly issued shares of the Company’s common stock based on December 31, 2013 book value per share, which approximated fair value.

Both steps of the transaction closed on July 31, 2014 and Westaim HIIG LP purchased 13,139,453 shares of the Company’s common stock for \$60 million on that date. The net cash proceeds to the Company were approximately \$56.0 million.

Immediately after the close of the transaction discussed above, Westaim HIIG LP purchased an additional \$25.0 million of the Company’s common stock at the audited book value per share of the common stock as of December 31, 2013 which approximated fair value. The Company issued 5,563,220 shares of common stock in connection with this transaction. The net cash proceeds to the Company from this transaction were approximately \$24.0 million after expenses. After these transactions, Westaim HIIG LP’s ownership increased to 71%.

As a result of the above transactions, there was a change in control of the Company as contemplated by Section 382 of the Internal Revenue Code; as a result, the utilization of the Company’s tax net operating loss in any one year will be significantly restricted. A valuation allowance for a substantial portion of the deferred tax asset related to the Company’s tax net operating loss carryforward was required. The valuation allowance related to the Company’s net operating loss carryforward is \$24.5 million and \$29.2 million at December 31, 2015 and 2014, respectively.

In January 2015, the Company and Westaim HIIG LP executed a subscription agreement whereby Westaim HIIG LP purchased approximately 14,213,487 shares of the Company’s common stock for \$70.0 million in cash, which was based on the December 31, 2014 book value per share which approximated fair value, bringing its total ownership to 76%.

In 2015, the Company purchased 3,076,924 shares of Westaim common stock for \$8.3 million. This investment is included in equity securities in the consolidated balance sheet as of December 31, 2015. The unrealized loss on this investment is \$1.2 million as of December 31, 2015.

Westaim performs consulting and certain other services for the Company pursuant to an agreement to provide management, consulting and certain other services (the Advisory Services Agreement). Pursuant to the Advisory Services Agreement, the Company is required to pay Westaim \$1.0 million per year, plus reasonable expenses incurred to provide the services. The Advisory Services Agreement will terminate on the earliest of (a) March 2019, (b) upon an Initial Public Offering or a change of control or (c) when Westaim HIIG LP owns less than 8% of the Company. Pursuant to the Advisory Services Agreement, the Company incurred fees of approximately \$1.0 million and \$0.5 million related to services provided by Westaim for each of the years ended December 31, 2015 and 2014, respectively.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

18. Change in Control and Related Party Transactions, continued

An earn-out liability is potentially due to former owners of assets acquired in 2012 and 2015 and former owners of businesses acquired in 2014 and 2011, some of whom are officers of a subsidiary of the Company, as discussed in Note 24. During 2015 and 2014, the liability was reduced by \$1.2 million and \$4 million, respectively, to approximate fair value which the Company recorded in other operating income for the years ended December 31, 2015 and 2014. Included in accounts payable and accrued liabilities is \$21.3 million and \$4.4 million of earn-out liability as of December 31, 2015 and 2014, respectively. Approximately \$0.7 million and \$0.8 million was paid during the years ended December 31, 2015 and 2014, respectively.

During 2015 and 2014, the Company provided insurance coverage, which is fully reinsured, in the form of a master high deductible policy to a commercial group property program sponsored by ClearView Risk Holdings, LLC. Included as a reduction of policy acquisition costs in the statement of operations are fronting fees of \$2.3 million and \$2.8 million in 2015 and 2014, respectively, related to this policy.

The Company also provides insurance coverage to a commercial group property program sponsored by another related party. The Company wrote \$70.6 million and \$11.5 million of premium in 2015 and 2014, respectively, related to this policy. Also included as a reduction of policy acquisition costs in the statement of operations are fees of \$0.3 million and \$0.9 million in 2015 and 2014, respectively, related to this policy.

During 2014, the Company entered into a note agreement with an employee of the Company for \$0.4 million. The note bears annual interest at 1.97%, due quarterly. Principal was due on June 30, 2015. The Company has the right to offset the note against future earn-out payments due to the employee. During 2015, a principal payment of \$0.1 million was received resulting in a note receivable balance of \$0.3 million which is included in other assets as of December 31, 2015. The remaining note was extended to June 2017.

See Notes 7 and 19 for additional related party transactions.

19. Commitments and Contingencies

Leases

The Company leases office space under various lease agreements expiring through 2023. The following is a schedule of future minimum annual lease payments (in thousands) on operating leases having initial or remaining non-cancelable lease terms in excess of one year:

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

19. Commitments and Contingencies, continued

Leases, continued

<u>Year Ended</u>	<u>Lease Payments</u>
2016	\$ 2,340
2017	2,440
2018	2,330
2019	1,587
2020	<u>818</u>
	<u>\$ 9,515</u>

Rent expense incurred under operating leases was approximately \$2.4 million and \$1.6 million for the years ended December 31, 2015 and 2014, respectively.

Litigation

The Company is named as a defendant in various legal actions arising from claims made under insurance policies and contracts. Those actions are considered by the Company in estimating the losses and loss adjustment expense reserves. Also, from time to time, the Company is a defendant in various legal actions that relate to disputes with third parties or that involve alleged errors and omissions. The Company records accruals for these items to the extent the losses are probable and reasonably estimable. Although the ultimate outcome of these matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from outside legal counsel, management believes the resolution of any such matters will not, individually or in the aggregate, have a material adverse effect on the consolidated financial position, results of operations or cash flows of the Company.

Indemnification

In conjunction with the sale of business assets and subsidiaries, the Company has provided indemnifications to the buyers. Certain indemnifications cover typical representations and warranties related to the responsibilities to perform under the sales contracts. The amount of potential exposure covered by the indemnifications is difficult to determine because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

19. Commitments and Contingencies, continued

Indemnification, continued

During 2012, the Company recorded a \$14.3 million provision for a loss, which was included in realized investment losses, related to indemnification claims made against it by the purchaser of a former subsidiary of the Company in accordance with the terms of the Equity Purchase Agreement executed by the parties in December 2010. The provision was reduced by \$2.0 million related to negotiating a recovery from another party. The remaining provision at December 31, 2015 is \$0.5 million. Management believes this remaining provision is the maximum remaining exposure that the Company has as a result of the indemnification claims.

Other commitments

During 2015, the Company executed a single managed account agreement with Arena for a total investment commitment of \$20.0 million. This commitment was unfunded as of December 31, 2015.

20. Regulatory Matters

A significant amount of the Company's consolidated assets represent assets of its insurance company subsidiaries, HSIC, IIC, GMIC and OSIC. IIC, OSIC and GMIC are all direct and indirect wholly owned subsidiaries of HSIC. HSIC is restricted by Texas law as to the amount of dividends it may pay without the approval of regulatory authorities. The maximum amount of dividends which can be paid by HSIC without prior approval is subject to restrictions relating to policyholder surplus, net income, and dividends declared or distributed during the preceding 12 months. As of December 31, 2015, HSIC can pay \$17.4 million in ordinary dividends subject to notice to the Texas Department of Insurance. HSIC did not declare or pay the Company any dividends for the two years ended December 31, 2015.

Property and casualty insurance companies are subject to certain Risk Based Capital (RBC) requirements as specified by the National Association of Insurance Commissioners (NAIC). Under those requirements, the amount of capital and surplus maintained by a property and casualty insurance company is to be determined based on the various risk factors related to it. At December 31, 2015 and 2014, the Company's insurance company subsidiaries met the RBC requirements.

The capital and surplus and RBC level of HSIC on a consolidated statutory basis (including IIC, GMIC and OSIC) as of and for the year ended December 31, 2015 and 2014 was as follows (in thousands):

	<u>2015</u>	<u>2014</u>
Statutory capital and surplus	\$ 268,851	\$ 263,641
RBC authorized control level	52,198	43,253

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Notes to Consolidated Financial Statements

21. Statutory Accounting Principles

The statutory capital and surplus for the Company's principal operating subsidiaries at December 31, 2015 and 2014 were as follows (in thousands):

	<u>2015</u>	<u>2014</u>
HSIC	\$ 268,851	\$ 263,641
OSIC	18,146	16,695
IIC	177,870	173,745
GMIC	107,575	102,958

These amounts include ownership interests in affiliated insurance subsidiaries.

The statutory net income (loss) for the Company's principal operating subsidiaries for the years ended December 31, 2015 and 2014 was as follows (in thousands):

	<u>2015</u>	<u>2014</u>
HSIC	\$ (5,849)	\$ 13,959
OSIC	1,447	297
IIC	567	7,989
GMIC	6,120	5,822

22. Fair Value

Assets and liabilities recorded at fair value in the consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Level inputs are as follows:

<u>Level Input</u>	<u>Input Definition</u>
Level 1	Inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.
Level 2	Inputs are other than quoted prices included in Level 1 that are observable for the asset or liability through corroboration with market data at the measurement date.
Level 3	Unobservable inputs that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date.

The following methods and assumptions were used by the Company in estimating the fair value disclosures for financial instruments in the accompanying consolidated financial statements and in these notes:

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Notes to Consolidated Financial Statements

22. Fair Value, continued

The Level 1 investments consist of U.S. Treasuries and equity securities traded in an active exchange market. The Company uses unadjusted quoted prices for identical instruments to measure fair value.

The Level 2 investments include most of our fixed income securities, which consist of U.S. government agency securities, municipal bonds, certain corporate debt securities and certain mortgage-backed and asset-backed securities. The Company measures fair value for the majority of the Level 2 investments using quoted prices of securities with similar characteristics.

The remaining investments are valued using pricing models or matrix pricing. The fair value measurements consider observable assumptions, including benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, default rates, loss severity and other economic measures.

The Company uses data provided by a third party investment manager to value its investments. The Company performs monthly analyses on the prices received from third parties to determine whether the prices are reasonable estimates of fair value. This analyses includes a review of month to month price fluctuations and, as needed, a comparison of pricing services' valuations to other pricing services' valuations for the identical security.

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Notes to Consolidated Financial Statements

22. Fair Value, continued

The following table summarizes fair value measurements by level at December 31, 2015 and 2014 for assets and liabilities measured at fair value on a recurring basis (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2015				
Fixed maturity securities:				
U.S. treasury securities	\$ 58,151	\$ -	\$ -	\$ 58,151
U.S. agency securities	-	4,992	-	4,992
Corporate securities	-	181,392	-	181,392
Municipal securities	-	72,440	-	72,440
Residential mortgage-back securities	-	71,731	-	71,731
Commercial mortgage-backed securities	-	25,982	-	25,982
Asset-backed securities	-	77,838	-	77,838
Total fixed maturity securities	<u>\$ 58,151</u>	<u>\$ 434,375</u>	<u>\$ -</u>	<u>\$ 492,526</u>
Mutual funds:				
Fixed income bond fund	<u>\$ 3,130</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,130</u>
Total mutual funds	<u>\$ 3,130</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,130</u>
Equity securities:				
Consumer discretionary	\$ 2,491	\$ -	\$ -	\$ 2,491
Consumer staples	3,873	-	-	3,873
Energy	2,327	-	-	2,327
Finance	16,473	-	-	16,473
Healthcare	4,985	-	-	4,985
Industrial	5,297	-	-	5,297
Information technology	3,094	-	-	3,094
Material	522	-	-	522
Utilities	170	-	-	170
Other	449	7	-	456
Total equity securities	<u>\$ 39,681</u>	<u>\$ 7</u>	<u>\$ -</u>	<u>\$ 39,688</u>
Short term investments	<u>\$ 40,473</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 40,473</u>
Grand total	<u>\$ 141,435</u>	<u>\$ 434,382</u>	<u>\$ -</u>	<u>\$ 575,817</u>

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

22. Fair Value, continued

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2014				
Fixed maturity securities:				
U.S. treasury securities	\$ 75,295	\$ -	\$ -	\$ 75,295
U.S. agency securities	-	16,305	-	16,305
Corporate securities	-	174,573	-	174,573
Municipal securities	-	42,071	-	42,071
Residential mortgage-back securities	-	79,889	-	79,889
Commercial mortgage-backed securities	-	31,268	-	31,268
Asset-backed securities	-	62,795	-	62,795
Total fixed maturity securities	<u>\$ 75,295</u>	<u>\$ 406,901</u>	<u>\$ -</u>	<u>\$ 482,196</u>
Mutual funds:				
Fixed income bond fund	<u>\$ 5,131</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,131</u>
Total mutual funds	<u>\$ 5,131</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,131</u>
Equity securities:				
Consumer discretionary	\$ 1,698	\$ -	\$ -	\$ 1,698
Consumer staples	2,629	-	-	2,629
Energy	2,026	-	-	2,026
Finance	4,813	-	-	4,813
Healthcare	2,261	-	-	2,261
Industrial	2,737	-	-	2,737
Information technology	1,831	-	-	1,831
Material	735	-	-	735
Utilities	182	-	-	182
Other	358	-	-	358
Total equity securities	<u>\$ 19,270</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 19,270</u>
Short term investments	<u>\$ 22,887</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 22,887</u>
Grand total	<u>\$ 122,583</u>	<u>\$ 406,901</u>	<u>\$ -</u>	<u>\$ 529,484</u>

The Company had no assets measured at fair value on a recurring basis using Level 3 inputs for the years ended December 31, 2015 and 2014.

During the years ended December 31, 2015 and 2014, certain securities, primarily certain mortgage-backed and asset-backed securities, were thinly traded due to concerns in the securities markets and the resulting lack of liquidity. Consequently, observable inputs were not always available and the fair values of these securities were estimated using internal estimates for inputs including, but not limited to, prepayments speeds, credit spreads, default rates and benchmark yields.

The Company measures certain assets, including the investments in affiliates, investments in partnerships and notes receivable, at fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. At December 31, 2015 and 2014, the fair value of the assets measured on a non-recurring basis was \$49.4 million and \$16.7 million, respectively. This fair value was determined using models with significant unobservable inputs.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.

Notes to Consolidated Financial Statements

22. Fair Value, continued

In addition to the preceding disclosures on assets and liabilities recorded at fair value in the consolidated balance sheets, guidance issued by FASB, also requires the disclosure of fair values for certain other financial instruments for which it is practicable to estimate fair value. Estimated fair value amounts, defined as the quoted market price of a financial instrument, have been determined using available market information and other appropriate valuation methodologies. However, considerable judgments are required in developing the estimates of fair value where quoted market prices are not available. Accordingly, these estimates are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions or estimating methodologies may have an effect on the estimated fair value amounts.

The following methods and assumptions were used by the Company in estimating the fair value disclosures of trust debenture securities and the note payable:

Trust debenture securities: The carrying value approximates the estimated fair value for the Company's trust debenture as the trust debenture accrues interest at current market rates.

Note payable: The carrying value approximates the estimated fair value for notes payable as the note payable accrues interest at current market rates.

Other financial instruments qualify as insurance-related products and are specifically exempted from fair value disclosure requirements.

23. Business Combination

Effective January 1, 2015, HIIGU acquired certain assets of Elite Underwriting Services a managing general underwriting agency based in Malvern, Pennsylvania specializing in excess medical insurance and other accident and health insurance products. The business assets were primarily comprised of client lists, trademarks and fixed assets. The initial purchase price was \$62 million in cash. The purchase agreement includes a contingency for future earnout payments up to \$18.0 million. The earnout is calculated over three years, based on achieving certain levels of pretax profit. The Company has accrued \$15.0 million, which approximates fair value of the contingent consideration, as part of the purchase price at December 31, 2015. The business combination was recorded using the purchase method of accounting. Accordingly, the purchase price has been allocated based on the fair value of the assets acquired, with \$74.4 million of the purchase price being allocated to goodwill, which is deductible for income tax purposes, and \$1.3 million allocated to other intangible assets.

Effective September 30, 2015, HIIGU acquired certain assets of Capital Risk Underwriters a managing general underwriting agency based in Orlando, Florida. The business assets were primarily comprised of a non-compete, client lists, trademarks and fixed assets. The initial purchase price was \$11.0 million in cash. The purchase agreement includes a contingency for future earnout payments of up to \$3.0 million, which had an estimated fair value of \$2.7 million. The earnout is calculated over three years, based on achieving certain levels of pretax profit. The Company has accrued \$2.7 million, which approximates the fair value of the contingent consideration, as part of the purchase price at December 31, 2015. The business combination was recorded using the purchase method of accounting.

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Notes to Consolidated Financial Statements

23. Business Combination, continued

Accordingly, the purchase price has been allocated based on the fair value of the assets acquired, with \$11.8 million allocated to goodwill, which is deductible for income tax purposes, and \$1.8 million allocated to other intangibles.

Effective July 1, 2014, HIIGU acquired Compass Group Partners, LLC (“Compass”). Compass specializes in Title Agents and Insurance Agents E&O Liability. The business assets were primarily comprised of client lists. The initial purchase price was \$1.2 million in cash. The purchase agreement includes a contingency for future earnout payments up to \$0.8 million which approximates fair value. The earnout is calculated over two years, based on achieving certain premium targets, and is paid out over two years. Due to the probability of paying the earnout, the Company has recorded the \$0.8 million earnout as part of the purchase price. The acquisition was recorded using the purchase method of accounting. The purchase price has been allocated based on the fair value of the assets acquired, with \$1.9 million allocated to goodwill, which is deductible for income tax purposes, and \$0.1 million allocated to other intangible assets.

24. Subsequent Events

Subsequent events have been evaluated through March 28, 2016, which is the date the financial statements were available to be issued.