Hilltop Holdings Inc.
Form 10-Q
November 10, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2008

OR

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

Commission File Number: 1-31987

Hilltop Holdings Inc.

(Exact name of registrant as specified in its charter)

MARYLAND	**84-1477939**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
200 Crescent Court, Suite 1330 **Dallas, Texas**	**75201**
(Address of principal executive offices)	(Zip Code)

(214) 855-2177

(Registrant's telephone number, including area code)

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

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

Large accelerated filer o	Accelerated filer ý	Non-accelerated filer o	Smaller reporting company o

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

The number of shares of the Registrant's common stock outstanding at November 10, 2008 was 56,455,515.

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HILLTOP HOLDINGS INC.

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2008

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HILLTOP HOLDINGS INC.

CONSOLIDATED BALANCE SHEETS

AS OF SEPTEMBER 30, 2008 AND DECEMBER 31, 2007

(in thousands, except share and per share data)

(unaudited)

	September 30, 2008	December 31, 2007
Assets		
Investments		
Fixed maturities		
Available for sale securities, at fair value (amortized cost of $125,078 and $130,253, respectively)	$ 121,434	$ 131,904
Held-to-maturity securities, at amortized cost (fair value of $14,495 and $6,819, respectively)	14,103	6,784
Equity securities		
Available for sale securities, at fair value (cost of $9,107 and $55,607, respectively)	8,141	52,336
Total investments	143,678	191,024
Cash and cash equivalents	750,573	783,008
Restricted cash	18,500	
Accrued interest and dividends	1,402	1,497
Premiums receivable	22,396	21,287
Deferred acquisition costs	16,887	14,521
Reinsurance receivable, net of uncollectible amounts	104,567	2,692
Prepaid reinsurance premiums	4,851	3,300
Income taxes receivable	27,019	
Deferred income taxes	16,278	22,219
Goodwill	23,988	23,613
Intangible assets, definite life	11,469	12,880
Intangible assets, indefinite life	3,000	3,000
Property and equipment, net	374	533
Loan origination costs, net	3,314	3,462
Other assets	1,937	2,455
Total Assets	$ 1,150,233	$ 1,085,491

The accompanying notes are an integral part of these consolidated financial statements.

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HILLTOP HOLDINGS INC.

CONSOLIDATED BALANCE SHEETS

AS OF SEPTEMBER 30, 2008 AND DECEMBER 31, 2007 (Continued)

(in thousands, except share and per share data)

(unaudited)

	September 30, 2008	December 31, 2007
Liabilities and Stockholders' Equity		
Liabilities		
Reserve for losses and loss adjustment expenses	$ 130,310	$ 18,091
Unearned premiums	72,494	68,410
Reinsurance payable	7,359	190
Accounts payable and accrued expenses	7,088	13,017
Income taxes payable		12,238
Notes payable	138,368	142,368
Dividends payable	1,719	1,719
Other liabilities	5,329	5,273
Total liabilities	362,667	261,306
Stockholders' Equity		
Preferred stock, no par value, 5,750,000 shares authorized, 5,000,000 shares issued and outstanding at September 30, 2008 and December 31, 2007; liquidation preference of $25 per share plus accrued but unpaid dividends	119,108	119,108
Common stock, $.01 par value, 100,000,000 shares authorized, 56,451,884 and 56,461,465 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	564	564
Additional paid-in capital	917,617	917,582
Accumulated other comprehensive loss	(2,997)	(1,053)
Accumulated deficit	(246,726)	(212,016)
Total stockholders' equity	787,566	824,185
Total liabilities and stockholders' equity	$ 1,150,233	$ 1,085,491

The accompanying notes are an integral part of these consolidated financial statements.

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HILLTOP HOLDINGS INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

(in thousands, except share and per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenue:				
Net premiums earned	$ 22,745	$ 26,265	$ 83,017	$ 69,462
Net investment income	6,716	10,003	21,887	13,273
Net realized (losses) gains on investments	(1,213)	(43)	(42,907)	141
Other income	1,503	1,785	4,674	4,844
Total revenue	29,751	38,010	66,671	87,720
Expenses:				
Loss and loss adjustment expenses	26,872	13,772	66,154	41,289
Policy acquisition and other underwriting expenses	10,736	8,949	32,350	23,472
General and administrative expenses	1,750	2,166	7,207	7,448
Depreciation and amortization	532	608	1,628	1,600
Interest expense	2,617	2,855	7,925	8,244
Total expenses	42,507	28,350	115,264	82,053
(Loss) Income from continuing operations before income tax benefit and allocation to minority interest	(12,756)	9,660	(48,593)	5,667
Income tax benefit (expense) from continuing operations	9,092	(3,389)	21,618	(2,003)
(Loss) Income from continuing operations before allocation to minority interest	(3,664)	6,271	(26,975)	3,664
Minority interest		(11)		112
(Loss) Income from continuing operations	(3,664)	6,260	(26,975)	3,776
Loss from discontinued operations		(2,212)		(11,125)
Gain on sale of discontinued operations		364,330		363,907
Income tax expense from discontinued operations		(74,234)		(76,563)
Minority interest in discontinued operations		86		494
Net (loss) income	(3,664)	294,230	(26,975)	280,489
Preferred stock dividend	(2,579)	(2,577)	(7,735)	(7,734)
Net (loss) income attributable to common stockholders	$ (6,243)	$ 291,653	$ (34,710)	$ 272,755
(Loss) Income per share from continuing operations less preferred dividends				
Basic (loss) income per share	$ (0.11)	$ 0.07	$ (0.61)	$ (0.07)
Diluted (loss) income per share	$ (0.11)	$ 0.06	$ (0.61)	$ (0.07)

Income per share from discontinued operations								
Basic income per share	$		$	5.10	$		$	5.02
Diluted income per share	$		$	5.06	$		$	4.92
(Loss) Income per share attributable to common stockholders								
Basic (loss) income per share	$	(0.11)	$	5.17	$	(0.61)	$	4.95
Diluted (loss) income per share	$	(0.11)	$	5.12	$	(0.61)	$	4.85
Weighted average share information								
Basic shares outstanding		56,452		56,446		56,452		55,071
Diluted shares outstanding		56,452		56,961		56,452		56,271

The accompanying notes are an integral part of these consolidated financial statements.

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HILLTOP HOLDINGS INC.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2008

(in thousands)

(unaudited)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount	Shares	Amount				
Balance, January 1, 2008	5,000	$119,108	56,461	$ 564	$ 917,582	$ (1,053)	$ (212,016)	$ 824,185
Net loss							(26,975)	(26,975)
Preferred stock dividends declared							(7,735)	(7,735)
Accumulated other comprehensive loss, net of tax						(1,944)		(1,944)
Total comprehensive loss								(36,654)
Common stock issued to board members			12		129			129
Shares redeemed			(21)		(215)			(215)
Stock compensation expense					121			121
Balance, September 30, 2008	5,000	$119,108	56,452	$ 564	$ 917,617	$ (2,997)	$ (246,726)	$ 787,566

The accompanying notes are an integral part of these consolidated financial statements.

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HILLTOP HOLDINGS INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

(in thousands)

(unaudited)

	For the Nine Months Ended September 30, 2008	2007
Cash flow from operating activities:		
Net (loss) income	$ (26,975)	$ 280,489
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities:		
Depreciation and amortization	1,628	1,600
Deferred income taxes	6,988	(1,121)
Increase in unearned premiums	4,084	18,164
Increase in deferred acquisition costs	(2,366)	(11,579)
Realized losses (gains) on investments	42,907	(141)
Purchases of trading securities		(419)
Proceeds from sales of trading securities		1,046
Amortization of loan origination costs	148	152
Stock grant compensation expense	35	1,547
Partnership preferred unit distributions declared		67
Minority interest		(179)
Adjustments related to discontinued operations		(277,768)
Changes in operating assets and liabilities	(29,891)	(2,110)
Net cash (used in) provided by operating activities	$ (3,442)	$ 9,748
Cash flow from investing activities:		
NLASCO acquisition		(115,502)
Cash acquired from NLASCO		45,457
Purchases of fixed assets	(59)	(293)
Restricted cash	(18,500)	
Purchases of available-for-sale securities	(39,801)	(38,017)
Purchases of held-to-maturity securities	(7,926)	(10)
Purchase of NALICO GA	(375)	
Proceeds from sales of available-for-sale securities	32,003	21,106
Proceeds from maturities of available-for-sale securities	11,244	
Proceeds from maturities of held-to-maturity securities	6,156	1,250
Proceeds from or purchases of assets related to discontinued operations		881,149
Net cash (used in) provided by investing activities	$ (17,258)	$ 795,140

The accompanying notes are an integral part of these consolidated financial statements.

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HILLTOP HOLDINGS INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007 (Continued)

(in thousands)

(unaudited)

	For the Nine Months Ended September 30, 2008	2007
Cash flow from financing activities:		
Cash flow from rights offering and stock issuances		
Common stock rights offering		80,000
Common stock offering expenses		(1,551)
Proceeds from issuances of common stock		20,000
Proceeds from issuance of debt		20,074
Repayment of debt	(4,000)	(30,986)
Payment of preferred dividends	(7,735)	(7,734)
Payment of partnership preferred distributions		(251)
Liquidation of OP Unit holders		(17,604)
Loan origination costs		(563)
Net cash (used in) provided by financing activities	(11,735)	61,385
Net (decrease) increase in cash and cash equivalents	(32,435)	866,273
Cash and cash equivalents, beginning of period	783,008	29,281
Cash and cash equivalents, end of period	$ 750,573	$ 895,554
Non-cash financing and investing transactions:		
Debt and other liabilities assumed in the NLASCO acquisition	$	$ 136,288
Redemption of OP units for common stock	$	$ 18,873
Fair value of common stock issued in the NLASCO acquisition	$	$ 13,359
Notes receivable issued for manufactured home sales	$	$ 2,829
Dividends declared but unpaid	$ 1,719	$ 1,719
Supplemental cash flow information:		
Cash paid for interest	$ 9,527	$ 7,015
Cash paid for income taxes	$ 10,634	$

The accompanying notes are an integral part of these consolidated financial statements.

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2008

(unaudited)

1. Business, Basis of Presentation and Summary of Significant Accounting Policies

Business

Hilltop Holdings Inc., formerly known as Affordable Residential Communities Inc. ("Hilltop", "HTH", or the "Company"), was organized in July 1998 as a Maryland corporation that was primarily engaged in the acquisition, renovation, repositioning and operation of all-age manufactured home communities, the retail sale and financing of manufactured homes, the rental of manufactured homes and other related businesses.

On January 31, 2007, we acquired all of the stock of NLASCO, Inc. ("NLASCO"), a privately held property and casualty insurance holding company. NLASCO is a Delaware corporation that specializes in providing fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States. NLASCO operates through its wholly-owned subsidiaries, National Lloyds Insurance Company ("NLIC") and American Summit Insurance Company ("ASIC"). Texas comprises approximately 74% of our business, with Arizona (9%), Tennessee (6%), Oklahoma (4%), Louisiana (2%), and the remaining states we do business in makes up the other 5%.

On July 31, 2007, the Company sold the manufactured home communities, retail sales and financing of manufactured home businesses to American Residential Communities LLC and retained ownership of NLASCO. In conjunction with this sale, the Company transferred the rights to the "Affordable Residential Communities" name, changed its name to Hilltop Holdings Inc., and moved its headquarters to Dallas, Texas. Our insurance operations are headquartered in Waco, Texas.

Our common stock is listed on the New York Stock Exchange under the symbol "HTH". Our Series A Cumulative Redeemable Preferred Stock is listed on the New York Stock Exchange under the symbol "HTH-PA". We have no public trading history prior to February 12, 2004.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America ("GAAP"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP, however, have been condensed or omitted pursuant to Article 10 of Regulation S-X. The consolidated financial statements include the accounts of all wholly-owned subsidiaries of the Company. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements.

Certain accounts have been reclassified to conform to the current period's presentation. In the opinion of management, these financial statements have been prepared on the same basis as the audited consolidated financial statements and include all adjustments necessary for the fair presentation of the Company's financial position, results of operations and cash flows. These adjustments were of a normal, recurring nature. The results of operations for the interim period ended September 30, 2008 are not indicative of the results that may be expected for the year ended December 31, 2008. Operating results and cash flows of NLASCO are for the eight months from the date of acquisition, January 31, 2007, through September 30, 2007, as compared to nine months for 2008. These financial statements

HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2008

(unaudited)

1. Business, Basis of Presentation and Summary of Significant Accounting Policies (Continued)

should be read in conjunction with the financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2007.

We are required by GAAP to make estimates and assumptions that affect our reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of our financial statements and our reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. These estimates and assumptions are particularly important in determining revenue recognition, reserves for losses and loss adjustment expenses, deferred policy acquisition costs, reinsurance receivables and potential impairment of assets.

Summary of Significant Accounting Policies

Restricted Cash

At September 30, 2008, $18.5 million of cash and cash equivalents is designated as restricted because of a guaranty provided by us with respect to a third-party loan made to a target we were pursuing. The loan of $18.2 million principal amount matures in February 2009 and is secured by auction rate securities pledged by the target. We, however, are no longer pursuing this target. There is sufficient collateral for the guaranty and, therefore, management believes no associated liability is necessary.

Recent Accounting Developments

In March 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 161, "Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133" (SFAS 161). SFAS 161 requires enhanced disclosures about an entity's derivative and hedging activities and strives to improve the transparency of financial reporting. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The scope of this Statement is the same scope as Statement 133. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The Company currently holds no derivative instruments and has no hedging activities; therefore, there is no impact of adopting SFAS 161 on its financial statements.

In September 2006, FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but rather, provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and the Company adopted SFAS 157 effective January 1, 2008 for financial assets and liabilities. The adoption of SFAS 157 had no accumulative effects on the Company's retained

HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2008

(unaudited)

1. Business, Basis of Presentation and Summary of Significant Accounting Policies (Continued)

earnings or accumulated deficit. In February 2008, FASB issued Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157, which delays, for one year, the effective date of SFAS 157 for nonfinancial assets and liabilities, except those that are recognized or disclosed in the financial statements on at least an annual basis. Accordingly, we deferred the adoption of SFAS 157 as it related to nonfinancial assets and liabilities until January 2009.

In December 2007, FASB issued Statement of Financial Accounting Standards No. 141(R), "Business Combinations" (SFAS 141(R)). This Statement will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes principles for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity's first fiscal year that begins after December 15, 2008. The Company does not expect the implementation of SFAS 141(R) to have a material impact on its consolidated financial statements.

In December 2007, FASB issued Statement of Financial Accounting Standards No. 160, "Noncontrolling Interests in Consolidated Financial Statements an Amendment of ARB No. 51" (SFAS 160). This Statement will significantly change the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2008, with early adoption permitted. The Company does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements.

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2008

(unaudited)

2. Investments

The amortized cost (original cost for equity securities), gross unrealized holding gains and losses, and fair value of available-for-sale and held-to-maturity securities by major security type and class of security at September 30, 2008 and December 31, 2007 were as follows (in thousands).

	September 30, 2008			
	Cost and Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Available-for-sale securities:				
Fixed maturities:				
Government securities	$ 36,983	$ 880	$ (824)	$ 37,039
Mortgage-backed securities	13,292	145	(2)	13,435
Corporate debt securities	74,804	240	(4,084)	70,960
	125,079	1,265	(4,910)	121,434
Equity securities	9,107		(966)	8,141
	134,186	1,265	(5,876)	129,575
Held-to-maturity securities:				
Fixed maturities:				
Government securities	14,103	414	(22)	14,495
	$ 148,289	$ 1,679	$ (5,898)	$ 144,070

	December 31, 2007			
	Cost and Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Available-for-sale securities:				
Fixed maturities:				
Government securities	$ 46,274	$ 1,275	$ (133)	$ 47,416
Mortgage-backed securities	12,661	155	(1)	12,815
Corporate debt securities	71,318	863	(508)	71,673
	130,253	2,293	(642)	131,904
Equity securities	55,607		(3,271)	52,336
	185,860	2,293	(3,913)	184,240
Held-to-maturity securities:				
Fixed maturities:				
Government securities	6,784	35		6,819

$192,644	$ 2,328	$ (3,913)	$191,059

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2008

(unaudited)

2. Investments (Continued)

The following table summarizes the length of time securities with unrealized losses at September 30, 2008 have been in an unrealized loss position (in thousands).

	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
Available-for-sale securities:						
Fixed maturities:						
Government securities	$ 4,001	$ (429)	$ 2,659	$ (395)	$ 6,660	$ (824)
Mortgage-backed securities	1,932	(2)			1,932	(2)
Corporate debt securities	45,777	(2,948)	8,628	(1,136)	54,405	(4,084)
	51,710	(3,379)	11,287	(1,531)	62,997	(4,910)
Equity securities	3,567	(18)	4,574	(948)	8,141	(966)
	55,277	(3,397)	$ 15,861	$ (2,479)	$ 71,138	$ (5,876)
Held-to-maturity securities:						
Fixed maturities:						
Government securities	1,440	(22)			1,440	(22)
	$ 56,717	$ (3,419)	$ 15,861	$ (2,479)	$ 72,578	$ (5,898)

In conjunction with the purchase of NLASCO on January 31, 2007, all "available-for-sale" securities were marked to their fair market value at that date. In the first and second quarter of 2008, the Company wrote down the value of equity securities held by HTH to market value, taking a loss of $41.9 million on these securities. These securities were sold and the Company recognized an additional $79,000 realized loss on the sale of the securities in September 2008. Generally, equity securities purchased by HTH are for strategic purposes, rather than investments. For the quarter ended September 30, 2008, the Company wrote down securities owned by NLASCO, Inc. of $1.1 million. While some of the securities held in the investment portfolio of NLASCO have also decreased in value since the date of acquisition, the Company has the ability and intent to hold these securities until maturity or until the value recovers and, therefore, does not feel any other impairments, other than temporary impairments, exist as of September 30, 2008.

Gross realized investment gains and losses for the three and nine months ended September 30, 2008 and 2007 are summarized as follows (in thousands).

	Three Months Ended September 30,					
	2008			2007		
	Gross Gains	Gross Losses	Total	Gross Gains	Gross Losses	Total
Fixed maturities	$ 48	$ (98)	$ (50)	$ 62	$ (61)	$ 1
Equity securities		(1,163)	(1,163)		(44)	(44)

	$ 48	$ (1,261)	$ (1,213)	$ 62	$ (105)	$ (43)

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2008

(unaudited)

2. Investments (Continued)

	Nine Months Ended September 30,					
	2008			2007		
	Gross Gains	Gross Losses	Total	Gross Gains	Gross Losses	Total
Fixed maturities	$261	$ (127)	$ 134	$ 68	$ (61)	$ 7
Equity securities		(43,041)	(43,041)	194	(60)	134
	$261	$(43,168)	$(42,907)	$262	$ (121)	$141

Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The schedule of fixed maturities of available-for-sale and held-to-maturity securities at September 30, 2008 and December 31, 2007 by contractual maturity are as follows (in thousands).

	September 30, 2008	
	Amortized Cost	Fair Value
Available-for-sale fixed maturities:		
Due within one year	$ 6,258	$ 6,107
Due after one year through five years	57,783	57,077
Due after six years through ten years	35,560	33,398
Due after ten years	12,185	11,417
Mortgage-backed securities	13,292	13,435
	$125,078	$121,434
Held-to-maturity debt securities:		
Due within one year	$ 485	$ 489
Due after one year through five years	7,448	7,654
Due after six years through ten years	6,170	6,352
Due after ten years		
	$ 14,103	$ 14,495

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2008

(unaudited)

2. Investments (Continued)

	December 31, 2007	
	Amortized Cost	Fair Value
Available-for-sale fixed maturities:		
Due within one year	$ 9,328	$ 9,338
Due after one year through five years	47,124	47,739
Due after six years through ten years	42,319	43,115
Due after ten years	18,821	18,897
Mortgage-backed securities	12,661	12,815
	$130,253	$131,904
Held-to-maturity debt securities:		
Due within one year	$ 5,138	$ 5,167
Due after one year through five years	1,228	1,234
Due after six years through ten years		
Due after ten years	418	418
	$ 6,784	$ 6,819

Net investment income for the three and nine months ended September 30, 2008 and 2007 is as follows (in thousands).

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	Change	2008	2007	Change
Cash equivalents	$4,846	$ 8,268	$(3,422)	$16,184	$ 8,915	$7,269
Fixed maturities	1,865	1,605	260	5,366	3,964	1,402
Equity securities	89	130	(41)	664	384	280
	6,800	10,003	(3,203)	22,214	13,263	8,951
Other income net of expenses	(84)		(84)	(327)	10	(337)
Net investment income	$6,716	$10,003	$(3,287)	$21,887	$13,273	$8,614

At September 30, 2008, the Company had on deposit in custody for various State Insurance Departments investments with carrying values totaling $14.1 million.

3. Fair Value Measurements

The Company's estimates of fair value for financial assets and financial liabilities are based on the framework established in SFAS 157. The framework is based on the inputs used in valuation and gives the highest priority to quoted prices in active markets and requires that observable inputs be used in the valuations when available. The disclosure of fair value estimates in the SFAS 157 hierarchy is based on whether the significant inputs into the valuation are observable. In determining the level of the hierarchy in which the estimate is disclosed, the highest priority is given to unadjusted quoted prices in

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(unaudited)

3. Fair Value Measurements (Continued)

active markets and the lowest priority to unobservable inputs that reflect the Company's significant market assumptions. The three levels of the hierarchy are as follows:

Level 1 Unadjusted quoted market prices for identical assets or liabilities in active markets that the Company has the ability to access.

Level 2 Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; or valuations based on models where the significant inputs are observable (e.g., interest rates, yield curves, prepayment speeds, default rates, loss severities, etc.) or can be corroborated by observable market data.

Level 3 Valuations based on models where significant inputs are not observable. The unobservable inputs reflect the Company's own assumptions about the assumptions that market participants would use.

The capital and credit markets have been experiencing volatility and disruption for more than 12 months. Recently the volatility and disruption has reached unprecedented levels, resulting in dramatic declines. This downward pressure has negatively affected the performance of our investments, which has resulted in the write-down of those investments. These write-downs, when determined to be other than temporary, reduce our earnings for that period. If current levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience additional losses on our investments and reductions to earnings.

The following table presents the hierarchy used by the Company by asset and liability type to determine their value at September 30, 2008 (in thousands).

	Total	Level 1	Level 2	Level 3
Financial assets:				
Cash and cash equivalents	$750,573	$750,573	$	$
Available-for-sale fixed maturities	121,434		107,874	13,560
Available-for-sale equity securities	8,141	8,141		
Total	$880,148	$758,714	$107,874	$13,560

Level 1 financial assets

The Company's Level 1 investments are limited to cash and cash equivalent balances and actively-traded debt and equity securities. Cash and cash equivalents are carried at amortized cost, which approximates fair value. Fair value of actively traded debt and equity securities are based on unadjusted quoted market prices.

Level 2 financial assets

Most of the Company's fixed maturity securities are classified in Level 2, including private and corporate debt and equity securities, federal agency and municipal bonds, and non-government mortgage and asset-backed securities. Fair values of inactively traded fixed maturity and equity

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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3. Fair Value Measurements (Continued)

securities are based on quoted market prices of identical or similar securities or based on observable inputs, such as interest rates, using either a market or income valuation approach and are generally classified as Level 2.

Level 3 financial assets

The Company's Level 3 fixed maturity securities include collateralized mortgage obligations and one corporate debt security. Fair values are based on inputs that are unobservable and significant to the overall fair value measurement, and involve management judgment. Inputs used to determine fair market value include market conditions, spread, volatility, structure and cash flows.

The following table includes a rollforward of the amounts at September 30, 2008 for financial instruments classified within level 3. The classification of a financial instrument within level 3 is based upon the significance of the unobservable inputs to the overall fair value measurement.

	Fair Value Measurements using Level 3 inputs
Balance at December 31, 2007	
Net Transfers In	14,469
Net Unrealized Losses	(909)
Balance at September 30, 2008	13,560

All level 3 financial assets transferred in occurred during the quarter ended September 30, 2008. There were no level 3 financial assets prior to September 30, 2008. All net unrealized losses in the table above are reflected in the accompanying financial statements. Net unrealized losses relate to those financial instruments held by the Company at September 30, 2008.

The following table presents the carrying value and fair value of assets and liabilities where they differ in value at September 30, 2008 (in thousands):

	September 30, 2008	
	Carrying Value	Fair Value
Financial assets		
Held to maturity fixed maturities	$ 14,103	$ 14,495
Financial liabilities		
Notes payable	$138,368	$151,334

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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4. Deferred Acquisition Costs

Policy acquisition expenses, primarily consisting of commissions, premium taxes and underwriting expenses related to issuing a policy, incurred by NLASCO are deferred and charged against income ratably over the terms of the related policies. The activity in deferred acquisition costs for the nine months ended September 30, 2008 is as follows (in thousands).

	Nine Months Ended September 30, 2008
Beginning of period deferred acquisition cost	$ 14,521
Acquisition expenses deferred	23,859
Amortization charged to income	(21,493)
End of period deferred acquisition costs	$ 16,887

5. Insurance Holding Company Line of Credit

Our insurance subsidiary has a line of credit with a financial institution. The line allows for borrowings by NLASCO of up to $5.0 million and is secured by substantially all of NLASCO's assets. The line of credit bears interest equal to a base rate less 0.5% (4.50% at September 30, 2008), which is due quarterly. This line is scheduled to mature in October 2009. During the nine months ended September 30, 2008, the principal balance on this note was paid down $4.0 million. The line of credit balance payable at September 30, 2008 is $18,000.

6. Reserve for Unpaid Losses and Loss Adjustment Expenses

A roll-forward of the reserve for unpaid losses and loss adjustment expenses for the nine months ended September 30, 2008 is as follows (in thousands).

Balance at January 1, 2008	$ 18,091
Less reinsurance recoverables	(2,692)
Net balance at January 1, 2008	15,399
Incurred related to:	
Current Year	65,314
Prior Year	840
Total incurred	66,154
Payments related to:	
Current Year	(48,812)
Prior Year	(6,998)
Total payments	(55,810)
Net balance at September 30, 2008	25,743
Plus reinsurance recoverables	104,567
Balance at September 30, 2008	$ 130,310

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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(unaudited)

6. Reserve for Unpaid Losses and Loss Adjustment Expenses (Continued)

The reserve for losses and loss adjustment expenses includes amounts that may be due to, or payable by, the sellers of NLASCO by January 2010 based on actual losses incurred as compared to the reserve as of the acquisition date. Prior year losses and payments include amounts back to the purchase of NLASCO on January 31, 2007 only, as all other prior losses and payments are the responsibility of the sellers.

7. Reinsurance Activity

NLASCO limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risk. Substantial amounts of business are ceded; however, these reinsurance contracts do not relieve NLASCO from its obligations to policyholders. Such reinsurance includes quota share, excess of loss, catastrophe, and other forms of reinsurance on essentially all property and casualty lines of insurance. Failure of reinsurers to honor their obligations could result in losses to NLASCO; consequently, allowances are established for amounts deemed uncollectible. NLASCO evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At September 30, 2008, we had reinsurance receivables with no allowance of approximately $104.6 million.

The effect of reinsurance on premiums written and earned for the three and nine months ended September 30, 2008 and 2007 is as follows (in thousands):

	Three Months Ended				**Nine Months Ended**			
	September 30, 2008		**September 30, 2007**		**September 30, 2008**		**September 30, 2007**	
	Written	**Earned**	**Written**	**Earned**	**Written**	**Earned**	**Written**	**Earned**
Premiums from direct business	$ 31,430	$ 33,984	$ 32,427	$ 30,776	$ 98,725	$ 98,444	$ 92,012	$ 73,277
Reinsurance assumed	1,365	1,402	1,637	1,264	4,134	4,574	5,369	2,373
Reinsurance ceded	(11,347)	(12,641)	(4,531)	(5,775)	(17,989)	(20,001)	(10,992)	(6,188)
Net premiums	$ 21,448	$ 22,745	$ 29,533	$ 26,265	$ 84,870	$ 83,017	$ 86,389	$ 69,462

The effect of reinsurance incurred losses was as follows (in thousands):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2008	**2007**	**2008**	**2007**
Loss and loss adjustment expense (LAE) incurred	$ 123,850	$ 14,532	$ 164,662	$ 42,991
Reinsurance recoverables	(96,978)	(760)	(98,508)	(1,702)
Net loss and LAE incurred	$ 26,872	$ 13,772	$ 66,154	$ 41,289

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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(unaudited)

7. Reinsurance Activity (Continued)

Multi-line excess of loss coverage

For all lines of business, ASIC's retention on any one risk for 2008 is $200,000 and NLIC's is $200,000.

Catastrophic coverage

NLASCO has five levels of catastrophic excess of loss reinsurance providing for coverage up to $200 million in 2008 above $1.0 million in retention for ASIC and $6.0 million for NLIC. NLASCO has an automatic reinstatement provision after the first loss for each layer to provide coverage in the event of subsequent catastrophes during the year. Coverage will lapse after the second or third event depending on the coverage layer, in which case NLASCO will evaluate the need for a new contract for the remainder of the year. During 2008, the first three layers can be reinstated twice for 100% of the original premium each time and the next two layers can be reinstated one time for 100% of the original premium.

For the quarter ended September 30, 2008, the Company experienced three significant catastrophes that resulted in losses in excess of retention. As of September 30, 2008, the total loss and loss adjustment expenses incurred associated with Hurricane Dolly was $6.4 million, however, since the losses exceeded retention, net exposure to the Company was $6.0 million retention and $14,000 in reinstatement premiums. Total loss and loss adjustment expenses incurred associated with Hurricane Gustav was $3.9 million, however, since the losses exceeded retention, net exposure to the Company was $1.0 million retention and $36,000 in reinstatement premiums. Total loss and loss adjustment expenses incurred associated with Hurricane Ike was $98.0 million, however, since the losses exceeded retention, net exposure to the Company was $7.0 million retention and $8.2 million in reinstatement premiums.

8. Income Taxes

At September 30, 2008, the Company had net operating loss carry-forwards for Federal income tax purposes, subject to certain limitations, of approximately $47.7 million and $49.0 million for regular income tax and alternative minimum tax, respectively. These net operating loss carry-forwards expire in 2018 through 2024. The net operating loss carry-forwards for alternative minimum Federal income taxes generally are limited to offsetting 90% of the alternative minimum taxable earnings for a given period.

In conjunction with the sale of the Company's manufactured housing business lines that closed on July 31, 2007, approximately $282.6 million of the Company's net operating loss carry forwards were utilized and $175.2 million of temporary taxable differences were recognized.

As of September 30, 2008, we had a deferred tax asset, net of liabilities, of $16.3 million. Our 35% rate reflects a change from the 40% rate utilized prior to the July 31, 2007 sale transaction as future taxable income of our insurance business will primarily be subject to Federal but not state income taxes. Insurance companies are generally not taxed in most states on income taxes, as they pay premium taxes in states where they generate premium revenue.

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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8. Income Taxes (Continued)

As a result of the allocation of the purchase price for the real estate assets we sold in 2007 by the purchaser, we reallocated $34.1 million of gain recognized to those assets in the quarter ended September 30, 2008, the period in which the purchase price allocation was finalized. This reallocation allowed us to utilize $34.1 million of our net operating loss carry forwards, which reduced our deferred tax asset by $11.9 million and increased our income tax receivable by the same amount. In addition, we were able to utilize $13.2 million of net operating losses that previously were limited under special IRS rules (the "Section 382 Limitations"), resulting in a deferred tax benefit of $4.6 million.

We allocate income taxes between continuing and discontinued operations in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes ("SFAS No. 109"), particularly paragraph 140. We recognize income tax benefits in continuing operations on the effective rate method and income tax expense in discontinued operations without such pro-ration in accordance with Accounting Principles Board Opinion 28 and ASB Interpretation No. 18.

Effective January 1, 2007, we adopted FASB Interpretation No. 48, which required the measurement of unrecognized tax benefits. Unrecognized tax benefits are the difference between a tax position taken, or expected to be taken, in a tax return and the benefit recognized for accounting purposes. For the period ending September 30, 2008 we had no unrecognized tax benefits.

We file tax returns as prescribed by the tax laws of the jurisdictions in which we operate. We are subject to tax audits in numerous jurisdictions in the U.S. until the applicable statute of limitations expires. The following is a summary of the tax years open to examination:

U.S. Federal	2005 through 2007
U.S. States	2004 through 2007

As of September 30, 2008, there are no Federal or State tax audits.

Under special IRS rules (the "Section 382 Limitation"), cumulative stock purchases by 5% shareholders exceeding 50% during a three year period can limit a company's future use of net operating losses (NOL's). We had a Section 382 ownership change in February 2004 at the time of the IPO.

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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8. Income Taxes (Continued)

The significant components of the provision for income taxes are as follows (in thousands):

	Three Months Ended September 30, 2008			Nine Months Ended September 30, 2008		
	Continuing Operations	Discontinued Operations	Total	Continuing Operations	Discontinued Operations	Total
Current tax benefit	$ 17,303	$ 11,919	$ 29,222	$ 16,581	$ 11,919	$ 28,500
Deferred tax expense	(12,814)	(11,919)	(24,733)	434	(11,919)	(11,485)
Allowance	4,603		4,603	4,603		4,603
Income tax benefit	$ 9,092	$	$ 9,092	$ 21,618	$	$ 21,618

	Three Months Ended September 30, 2007			Nine Months Ended September 30, 2007		
	Continuing Operations	Discontinued Operations	Total	Continuing Operations	Discontinued Operations	Total
Current tax expense	$ (5,353)	$ (74,234)	$ (79,587)	$ (3,124)	$ (76,563)	$ (79,687)
Deferred tax benefit (expense)	1,964	(59,930)	(57,966)	1,121	(43,402)	(42,281)
Allowance		59,930	59,930		43,402	43,402
Income tax expense	$ (3,389)	$ (74,234)	$ (77,623)	$ (2,003)	$ (76,563)	$ (78,566)

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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(unaudited)

8. Income Taxes (Continued)

The provision for income taxes differs from the amount that would be computed by applying the statutory Federal income tax rate of 35% to income before income taxes as a result of the following (in thousands):

	Three Months Ended September 30, 2008			Nine Months Ended September 30, 2008		
	Continuing Operations	Discontinued Operations	Total	Continuing Operations	Discontinued Operations	Total
Tax at statutory rate	$ 4,465	$	$ 4,465	$ 17,007	$	$ 17,007
Permanent differences	24		24	8		8
Decrease in valuation allowance	4,603		4,603	4,603		4,603
Income tax benefit	$ 9,092	$	$ 9,092	$ 21,618	$	$ 21,618

	Three Months Ended September 30, 2007			Nine Months Ended September 30, 2007		
	Continuing Operations	Discontinued Operations	Total	Continuing Operations	Discontinued Operations	Total
Tax at statutory rate	$ (3,381)	$ (126,741)	$(130,122)	$ (1,983)	$ (123,474)	$(125,457)
Permanent differences	(8)	9,857	9,849	(20)	21,148	21,128
State taxes		(17,280)	(17,280)		(17,639)	(17,639)
Decrease in valuation allowance		59,930	59,930		43,402	43,402
Income tax expense	$ (3,389)	$ (74,234)	$ (77,623)	$ (2,003)	$ (76,563)	$ (78,566)

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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(unaudited)

8. Income Taxes (Continued)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of the assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The tax effects of significant temporary differences that give rise to the net deferred tax assets and liabilities are as follows (in thousands):

	September 30, 2008	December 31, 2007
Deferred Tax Assets:		
Net operating loss carryforwards	$ 16,680	$ 28,600
Accrued liabilities and other	874	2,180
Loss and loss adjustment expense discounting	652	708
Securities available for sale	1,827	542
Unearned premiums	6,985	4,665
Loan origination costs	413	436
AMT credit carryforward	256	256
Valuation allowance		(4,603)
Total gross deferred tax assets	$ 27,687	$ 32,784
Deferred Tax Liabilities:		
Rental and other property, net	$ 21	$ 14
Intangible assets	5,015	5,558
Goodwill	146	171
Deferred policy acquisition costs	6,227	4,822
Total gross deferred tax liabilities	$ 11,409	$ 10,565
Net Deferred Tax Asset	$ 16,278	$ 22,219

9. Statutory Net Income and Capital and Surplus

The Company's insurance subsidiaries, which are domiciled in the State of Texas, prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the Texas Department of Insurance, which Texas recognizes for determining solvency under Texas State Insurance Law. The Commissioner of the Texas Department of Insurance has the right to permit other practices that may deviate from prescribed practices. Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in Texas. Permitted statutory accounting practices encompass all accounting practices that are not prescribed; such practices differ from state to state, may differ from company to company within a state, and may change in the future. The Company's insurance subsidiaries have no such permitted statutory accounting practices.

The Company's insurance subsidiaries' statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the Texas Department of Insurance. Texas had adopted the National Association of Insurance Commissioners' (NAIC) statutory accounting practices as the

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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(unaudited)

9. Statutory Net Income and Capital and Surplus (Continued)

basis of its statutory accounting practices with certain differences, which are not significant to the companies' statutory equity.

Following is a summary of statutory capital and surplus and statutory net income of each insurance subsidiary for the three and nine months ended September 30, 2008 and 2007 (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
National Lloyds Insurance Company				
Capital and surplus	$81,667	$92,300	$81,667	$92,300
Statutory net (loss) income	$ (6,929)	$ 3,184	$ (6,445)	$ 9,419
American Summit Insurance Company				
Capital and surplus	$23,212	$24,490	$23,212	$24,490
Statutory net (loss) income	$ (837)	$ 1,386	$ 602	$ 2,804

10. Capital and Dividend Restrictions

The funding of the cash requirements (including debt service) of NLASCO is primarily provided by cash dividends from NLASCO's wholly-owned insurance subsidiaries. Dividends paid by the insurance subsidiaries are restricted by regulatory requirements of the Texas Department of Insurance. Under Texas State Insurance Law for property and casualty companies, all dividends must be distributed out of earned surplus only. Furthermore, without the prior approval of the Commissioner, dividends cannot be declared or distributed which exceed the greater of ten percent of NLASCO's surplus, as shown by its last statement on file with the Commissioner, or 100% of net income for such period. The subsidiaries paid $14.0 million in dividends to NLASCO in March 2008. At September 30, 2008, the maximum dividend that may be paid to NLASCO in 2008 without regulatory approval is an additional $7.3 million.

Regulations of the Texas Department of Insurance require insurance companies to maintain minimum levels of statutory surplus to ensure their ability to meet their obligations to policyholders. At September 30, 2008, the Company's insurance subsidiaries had statutory surplus in excess of the minimum required.

Also, the NAIC has adopted the risk based calculation formula for insurance companies that establishes minimum capital requirements relating to insurance risk, asset credit risk (RBC ratio), interest rate risk and business risk. The formula is used by the NAIC and certain state insurance regulators as an early warning tool to identify companies that require additional scrutiny or regulatory action. At September 30, 2008, the Company's insurance subsidiaries' RBC ratio exceeded the level at which regulatory action would be required.

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HILLTOP HOLDINGS INC.

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11. Equity and Loss per share

The following reflects the calculation of loss per share on a basic and diluted basis (in thousands, except per share information).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Income (Loss) per share from continuing operations:				
(Loss) Income from continuing operations	$(3,664)	$ 6,260	$(26,975)	$ 3,776
Preferred stock dividends	(2,579)	(2,577)	(7,735)	(7,734)
(Loss) Income from continuing operations	$(6,243)	$ 3,683	$(34,710)	$(3,958)
Basic (loss) income per share from continuing operations	$ (0.11)	$ 0.07	$ (0.61)	$ (0.07)