HALLMARK FINANCIAL SERVICES INC
Form 10-K
March 22, 2007

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

FORM 10-K

(Mark One)
[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended DECEMBER 31, 2006

Or

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

For the transition period from ____________________ to ____________________________

Commission file number **001-11252**
Hallmark Financial Services, Inc.
(Exact name of registrant as specified in its charter)

Nevada	87-0447375
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
777 Main Street, Suite 1000, Fort Worth, Texas	76102
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Code: **(817) 348-1600**

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock $.18 par value	Nasdaq Global Market

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes__ No_X_

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes__ No_X_

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 _X_ No ___

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ____

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer __ Accelerated filer __ Non-accelerated filer X

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. $33,564,189

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. Common stock, $.18 par value 20,768,238 shares outstanding as of March 15, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.
Unless the context requires otherwise, in this Form 10-K the term "Hallmark" refers solely to Hallmark Financial Services, Inc. and the terms "we," "our," and "us" refer to Hallmark and its subsidiaries. The direct and indirect subsidiaries of Hallmark are referred to in this Form 10-K in the manner identified in the chart under "Item 1. Business - Operational Structure. "

Risks Associated with Forward-Looking Statements Included in this Form 10-K

This Form 10-K contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which are intended to be covered by the safe harbors created thereby. Forward-looking statements include statements which are predictive in nature, which depend upon or refer to future events or conditions, or which include words such as "expect," "anticipate," "intend," "plan," "believe," "estimate" or similar expressions. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of our business activities and availability of funds. Statements regarding the following subjects are forward-looking by their nature:

- our business and growth strategies;
- our performance goals;
- our projected financial condition and operating results;
- our understanding of our competition;
- industry and market trends;

- the impact of technology on our products, operations and business; and

- any other statements or assumptions that are not historical facts.

The forward-looking statements included in this Form 10-K are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to these forward-looking statements involve judgments with respect to, among other things, future economic, competitive and market conditions, regulatory framework, weather-related events and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying these forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-K will prove to be accurate. In light of the significant uncertainties inherent in these forward-looking statements, the inclusion of such information should not be regarded as a representation that our objectives and plans will be achieved.

PART I

Item 1. Business.

Who We Are

We are a diversified property/casualty insurance group that serves businesses and individuals in specialty and niche markets. We offer standard commercial insurance, specialty commercial insurance and personal insurance in selected market subcategories that are characteristically low-severity and short-tailed risks. We focus on marketing, distributing, underwriting and servicing property/casualty insurance products that require specialized underwriting expertise or market knowledge. We believe this approach provides us the best opportunity to achieve favorable policy terms and pricing. The insurance policies we produce are written by our three insurance company subsidiaries as well as unaffiliated insurers.

We market, distribute, underwrite and service our property/casualty insurance products through four operating units, each of which has a specific focus. Our HGA Operating Unit primarily handles standard commercial insurance, our TGA Operating Unit concentrates on excess and surplus lines commercial insurance, our Aerospace Operating Unit specializes in general aviation insurance and our Phoenix Operating Unit focuses on non-standard personal automobile insurance. The subsidiaries comprising our TGA Operating Unit and our Aerospace Operating Unit were acquired effective January 1, 2006.

Each operating unit has its own management team with significant experience in distributing products to its target markets and proven success in achieving underwriting profitability and providing efficient claims management. Each operating unit is responsible for marketing, distribution, underwriting and claims management while we provide capital management, reinsurance, actuarial, investment, financial reporting, technology and legal services and back office support at the parent level. We believe this approach optimizes our operating results by allowing us to effectively penetrate our selected specialty and niche markets while maintaining operational controls, managing risks, controlling overhead and efficiently allocating our capital across operating units.

We expect future growth to be derived from increased retention of the premiums we write, organic growth in the premium production of our existing operating units and selected, opportunistic acquisitions that meet our criteria. In 2005, we increased the capital of our insurance company subsidiaries, enabling them to retain significantly more of the business produced by our operating units. For the year ended December 31, 2006, 69.2% of the total premium we produced was retained by our insurance company subsidiaries, while the remaining 30.8% was written for or ceded to unaffiliated insurers. We expect to continue to increase our retention of the total premium we produce. We believe

increasing our overall retention will drive greater near-term profitability than focusing solely on growth in premium production and market share.

What We Do

We market standard commercial, specialty commercial and personal property/casualty insurance products which are tailored to the risks and coverages required by the insured. We believe that most of our target markets are underserved by larger property/casualty underwriters because of the specialized nature of the underwriting required. We are able to offer these products profitably as a result of the expertise of our experienced underwriters. We also believe our long-standing relationships with independent general agencies and retail agents and the service we provide differentiate us from larger property/casualty underwriters.

Our HGA Operating Unit primarily underwrites low-severity, short-tailed commercial property/casualty insurance products in the standard market. These products have historically produced stable loss results and include general liability, commercial automobile, commercial property and umbrella coverages. Our HGA Operating Unit currently markets its products through a network of approximately 190 independent agents primarily serving businesses in the non-urban areas of Texas, New Mexico, Oregon, Idaho, Montana and Washington.

Our TGA Operating Unit primarily offers commercial property/casualty insurance products in the excess and surplus lines market. Excess and surplus lines insurance provides coverage for difficult to place risks that do not fit the underwriting criteria of insurers operating in the standard market. Our TGA Operating Unit focuses on small- to medium-sized commercial businesses that do not meet the underwriting requirements of standard insurers due to factors such as loss history, number of years in business, minimum premium size and types of business operation. Our TGA Operating Unit primarily writes general liability, commercial automobile and commercial property policies. Our TGA Operating Unit markets its products through 38 independent general agencies with offices in Texas, Louisiana, Oklahoma and Arkansas, as well as 751 independent retail agents in Texas.

Our Aerospace Operating Unit offers general aviation property/casualty insurance primarily for private and small commercial aircraft and airports. The aircraft liability and hull insurance products underwritten by our Aerospace Operating Unit are targeted to transitional or non-standard pilots who may have difficulty obtaining insurance from a standard carrier. Airport liability insurance is marketed to smaller, regional airports. Our Aerospace Operating Unit markets these general aviation insurance products through 215 independent specialty brokers in 47 states.

Our Phoenix Operating Unit currently offers non-standard personal automobile policies which generally provide the minimum limits of liability coverage mandated by state law to drivers who find it difficult to obtain insurance from standard carriers due to various factors including age, driving record, claims history or limited financial resources. Our Phoenix Operating Unit markets this non-standard personal automobile insurance through approximately 1,155 independent retail agents in Texas, New Mexico, Arizona, Oklahoma, Arkansas, Idaho, Oregon and Washington.

Our insurance company subsidiaries are American Hallmark Insurance Company of Texas ("AHIC"), Phoenix Indemnity Insurance Company ("PIIC") and Gulf States Insurance Company ("GSIC"). Effective January 1, 2006, our insurance company subsidiaries entered into a pooling arrangement, which was subsequently amended on December 15, 2006, pursuant to which AHIC would retain 46.0% of the net premiums written, PIIC would retain 34.1% of the net premiums written and GSIC would retain 19.9% of the net premiums written. As of June 5, 2006, A.M. Best Company ("A.M. Best"),

a nationally recognized insurance industry rating service and publisher, pooled its ratings of our three insurance company subsidiaries and assigned a financial strength rating of "A-" (Excellent) and an issuer credit rating of "a-" to each of our individual insurance company subsidiaries and to thepool formed by our insurance company subsidiaries.

Our four operating units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment presently consists solely of the HGA Operating Unit and the Personal Segment presently consists solely of our Phoenix Operating Unit. The Specialty Commercial Segment includes both our TGA Operating Unit and our Aerospace Operating Unit. The following table displays the gross premiums produced by these reportable segments for affiliated and unaffiliated insurers for the years ended December 31, 2006, 2005 and 2004, as well as the gross premiums written and net premiums written by our insurance subsidiaries for these reportable segments for the same periods.

	2006	2005	2004
	(dollars in thousands)		
Gross Premiums Produced:			
Standard Commercial Segment	$ 91,679	$ 81,721	$ 75,808
Specialty Commercial Segment (1)	156,490	-	-
Personal Segment	45,135	36,345	

			43,497
Total	$ 293,304	$ 118,066	$ 119,305
Gross Premiums Written:			
Standard Commercial Segment	$ 91,070	$ 52,952	$ -
Specialty Commercial Segment (1)	77,740	-	-
Personal Segment	45,135	36,515	33,389

Total	$	213,945	$	89,467	$	33,389
Net Premiums Written:						
Standard Commercial Segment	$	82,220	$	51,249	$	-
Specialty Commercial Segment (1)		75,573		-		-
Personal Segment		45,135		37,003		33,067

Total	$ 202,928	$ 88,252	$ 33,067

1 The subsidiaries included in the Specialty Commercial Segment were acquired effective January 1, 2006 and, therefore, are not included in the years ended December 31, 2005 and 2004.

Operational Structure

Our insurance company subsidiaries retain a portion of the premiums produced by our operating units. The following chart reflects the operational structure of our organization, the subsidiaries comprising our operating units and the operating units included in each reportable segment as of December 31, 2006.

Standard Commercial Segment / HGA Operating Unit

The Standard Commercial Segment of our business presently consists solely of our HGA Operating Unit. Our HGA Operating Unit markets, underwrites and services standard commercial lines insurance primarily in the non-urban areas of Texas, New Mexico, Idaho, Oregon, Montana and Washington. The subsidiaries comprising our HGA Operating Unit include Hallmark General Agency, a regional managing general agency, and ECM, a claims administration company. Hallmark General Agency targets customers that are in low-severity classifications in the standard commercial market, which as a group have relatively stable loss results. The typical customer is a small- to medium-sized business with a policy that covers property, general liability and automobile exposures. Our HGA Operating Unit underwriting criteria exclude lines of business and classes of risks that are considered to be high-severity or volatile, or which involve significant latent injury potential or other long-tailed liability exposures. ECM administers the claims on the insurance policies produced by Hallmark General Agency. Products offered by our HGA Operating Unit include the following:

- Commercial automobile.

  Commercial automobile insurance provides third-party bodily injury and property damage coverage and first-party property damage coverage against losses resulting from the ownership, maintenance or use of automobiles and trucks in connection with an insured's business.

- General liability.

  General liability insurance provides coverage for third-party bodily injury and property damage claims arising from accidents occurring on the insured's premises or from their general business operations.

- Umbrella.

  Umbrella insurance provides coverage for third-party liability claims where the loss amount exceeds coverage limits provided by the insured's underlying general liability and commercial automobile policies.

- Commercial property.

  Commercial property insurance provides first-party coverage for the insured's real property, business personal property, and business interruption losses caused by fire, wind, hail, water damage, theft, vandalism and other insured perils.

- Commercial multi-peril.

  Commercial multi-peril insurance provides a combination of property and liability coverage that can include commercial automobile coverage on a single policy.

- Business owner's.

Business owner's insurance provides a package of coverage designed for small- to medium-sized businesses with homogeneous risk profiles. Coverage includes general liability, commercial property and commercial automobile.

Our HGA Operating Unit markets its property/casualty insurance products through approximately 190 independent agencies operating in its target markets. Our HGA Operating Unit applies a strict agent selection process and seeks to provide its independent agents some degree of non-contractual geographic exclusivity. Our HGA Operating Unit also strives to provide its independent agents with convenient access to product information and personalized service. As a result, the Standard Commercial Segment has historically maintained excellent relationships with its producing agents,

as evidenced by the 17-year average tenure of the 26 agency groups which each produced more than $1.0 million in premium during the year ended December 31, 2006. During 2006, the top ten agency groups produced 38%, and no individual agency group produced more than 9%, of the total premium volume of our HGA Operating Unit.

Our HGA Operating Unit writes most risks on a package basis using a commercial multi-peril policy or a business owner's policy. Umbrella policies are written only when our HGA Operating Unit also writes the insured's underlying general liability and commercial automobile coverage. Through December 31, 2005, our HGA Operating Unit marketed policies on behalf of Clarendon National Insurance Company ("Clarendon"), a third-party insurer. Our HGA Operating Unit earns a commission based on a percentage of the earned premium it produced for Clarendon. The commission percentage is determined by the underwriting results of the policies produced. ECM receives a claim servicing fee based on a percentage of the earned premium produced, with a portion deferred for casualty claims. On July 1, 2005, our HGA Operating Unit began marketing new policies for AHIC and presently markets all new and renewal policies exclusively for AHIC.

All of the commercial policies written by our HGA Operating Unit are for a term of 12 months. If the insured is unable or unwilling to pay for the entire premium in advance, we provide an installment payment plan that allows the insured to pay 20% down and the remaining payments over eight months. We charge a flat $7.50 installment fee per payment for the installment payment plan.

Specialty Commercial Segment

The Specialty Commercial Segment of our business includes both our TGA Operating Unit and our Aerospace Operating Unit. All of the subsidiaries comprising our TGA Operating Unit and our Aerospace Operating Unit were acquired effective January 1, 2006. Our TGA Operating Unit and our Aerospace Operating Unit were reported as separate segments during the first three quarters of 2006, but were aggregated into a single segment commencing in the fourth quarter of 2006 in accordance with U.S. generally accepted accounting principles ("GAAP"). During 2006, our TGA Operating Unit accounted for approximately 80.7% of the aggregate premiums produced by the Specialty Commercial Segment, with the remaining 19.3% coming from our Aerospace Operating Unit.

TGA Operating Unit.

Our TGA Operating Unit markets, underwrites, finances and services commercial lines insurance in Texas, Louisiana, Arkansas and Oklahoma with a particular emphasis on commercial automobile, general liability and commercial property risks produced on an excess and surplus lines basis. Excess and surplus lines insurance provides coverage for difficult to place risks that do not fit the underwriting criteria of insurers operating in the standard market. Our TGA Operating Unit also markets, underwrites and services certain non-strategic legacy personal lines insurance products in Texas, including dwelling fire, homeowners and non-standard personal automobile coverages. Our TGA Operating Unit intends to transition its current non-standard personal automobile coverages to similar products offered by our Phoenix Operating Unit during 2007. We are currently evaluating options for the other legacy personal lines products offered by our TGA Operating Unit, including the possibility of offering them through our Phoenix Operating Unit. The subsidiaries comprising our TGA Operating Unit include Texas General Agency, which is a regional managing general agency, TGASRI, which brokers mobile home insurance, and PAAC, which provides premium financing for policies marketed by Texas General Agency and certain unaffiliated general and retail agents. Texas General Agency accounts for approximately 95% of the premium volume financed by PAAC.

Our TGA Operating Unit focuses on small- to medium-sized commercial businesses that do not meet the underwriting requirements of traditional standard insurers due to issues such as loss history, number of years in business, minimum premium size and types of business operation. During 2006, commercial automobile, general liability and commercial property insurance accounted for approximately 92.5% of the premiums produced by our TGA Operating Unit, with the remaining 7.5% coming from legacy personal lines products. Target risks for commercial automobile insurance are small- to medium-sized businesses with ten or fewer vehicles which include artisan contractors, local light- to

medium-service vehicles and retail delivery vehicles. Target risks for general liability insurance are small business risk exposures including artisan contractors, sales and service organizations, and building and premiums exposures. Target risks for commercial property insurance are low- to mid-value structures including office buildings, mercantile shops, restaurants and rental dwellings, in each case with aggregate property limits of less than $500 thousand. The commercial insurance products offered by our TGA Operating Unit include the following:

- Commercial automobile.

  Commercial automobile insurance provides third-party bodily injury and property damage coverage and first-party property damage coverage against losses resulting from the ownership, maintenance or use of automobiles and trucks in connection with an insured's business.

- General liability.

  General liability insurance provides coverage for third-party bodily injury and property damage claims arising from accidents occurring on the insured's premises or from their general business operations.

- Commercial property.

Commercial property insurance provides first-party coverage for the insured's real property, business personal property, theft and business interruption losses caused by fire, wind, hail, water damage, theft, vandalism and other insured perils. Windstorm, hurricane and hail are generally excluded in coastal areas.

Our TGA Operating Unit produces business through a network of 38 general agents with 50 offices in four states, as well as through 751 retail agents in Texas. Our TGA Operating Unit strives to simplify the placement of its excess and surplus lines policies by providing prompt quotes and signature-ready applications to its independent agents. During 2006, general agents accounted for 77.9% of total premiums produced by our TGA Operating Unit, with the remaining 22.1% being produced by retail agents. During 2006, the top ten general agents produced 43.9%, and no general agent produced more than 9%, of the total premium volume of our TGA Operating Unit. During the same period, the top ten retail agents produced 4.1%, and no retail agent produced more than 1%, of the total premium volume of our TGA Operating Unit.

All business of our TGA Operating Unit is currently produced under a fronting agreement with member companies of the Republic Group ("Republic") which grants our TGA Operating Unit the authority to develop underwriting programs, set rates, appoint retail and general agents, underwrite risks, issue policies and adjust and pay claims. AHIC presently assumes 50% of the premium written under this fronting agreement pursuant to a reinsurance agreement with Republic which expires on December 31, 2008. Under these arrangements, AHIC may assume a maximum of 50% of the written premium produced in 2006, 60% of the written premium produced in 2007 and 70% of the written premium produced in 2008. Commission revenue is also generated under the fronting agreement on the portion of premiums not assumed by AHIC. An additional commission may be earned if certain loss ratio targets are met. Additional revenue is generated from fully earned policy fees and installment billing fees charged on the legacy personal lines products.

The majority of the commercial policies written by our TGA Operating Unit are for a term of 12 months. Exceptions include a few commercial automobile policies that are written for a term that coincides with the annual harvest of crops and special event general liability policies that are written for the term of the event, which is generally one to two days. Commercial lines policies are paid in full up front or financed with various premium finance companies, including PAAC. Non-standard personal automobile policies are written on a monthly or semiannual term. Homeowner and dwelling fire polices are written for a term of 12 months. These legacy personal lines policies are all billed in monthly installments.

Aerospace Operating Unit.

Our Aerospace Operating Unit markets, underwrites and services general aviation property/casualty insurance in 47 states. The subsidiaries comprising our Aerospace Operating Unit include Aerospace Insurance Managers, which markets standard aviation coverages, ASRI, which markets excess and surplus lines aviation coverages, and ACMG, which handles claims management. Aerospace Insurance Managers is one of only a few similar entities in the U.S. and has focused on developing a well-defined niche centering on transitional pilots, older aircraft and small airports and aviation-related businesses. Products offered by our Aerospace Operating Unit include the following:

- Aircraft.

  Aircraft insurance provides third-party bodily injury and property damage coverage and first-party hull damage coverage against losses resulting from the ownership, maintenance or use of aircraft.

- Airport liability.

Airport liability insurance provides coverage for third-party bodily injury and property damage claims arising from accidents occurring on airport premises or from their operations.

Our Aerospace Operating Unit generates its business through approximately 215 aviation specialty brokers. These specialty brokers submit to Aerospace Insurance Managers requests for aviation insurance quotations received from the states in which we operate and our Aerospace Operating Unit selectively determine the risks fitting its target niche for which it will prepare a quote. During 2006, the top ten independent specialty brokers produced 47.0% of the total premium volume of our Aerospace Operating Unit. During this period, the largest broker produced 15.0%, and no other broker produced more than 6%, of the total premium volume of our Aerospace Operating Unit.

Our Aerospace Operating Unit independently develops, underwrites and prices each coverage written. We target pilots who may lack experience in the type of aircraft they have acquired or are transitioning between types of aircraft. We also target pilots who may be over the age limits of other insurers. We do not accept aircraft that are used for hazardous purposes such as crop dusting or aerial acrobatics. Liability limits are controlled, with approximately 94% of the aircraft written in 2006 bearing per-occurrence limits of $1,000,000 and per-passenger limits of $100,000 or less. The average insured aircraft hull value for aircraft written in 2006 was $127,869.

Prior to July 1, 2006, our Aerospace Operating Unit produced policies for American National Property & Casualty Insurance Company under a reinsurance program which ceded 100% of the business to several reinsurers. Under this arrangement, revenue was generated primarily from commissions based on written premiums net of cancellations and endorsement return premiums. An additional commission may be earned based upon the profitability of the business to the reinsurers. Beginning July 1, 2006, we began issuing general aviation policies written by PIIC in the 27 states in which PIIC was licensed for aviation insurance products. We intend to continue to migrate the business produced by our Aerospace Operating Unit into PIIC as it acquires additional licenses for aviation, and expect to complete this process by early 2008.

Personal Segment / Phoenix Operating Unit

The Personal Segment of our business presently consists solely of our Phoenix Operating Unit. Our Phoenix Operating Unit currently markets and services non-standard personal automobile policies in Texas, New Mexico, Arizona, Oklahoma, Arkansas, Idaho, Oregon and Washington. We conduct this business under the name Phoenix General Agency. Phoenix General Agency provides management, policy and claims administration services to PIIC and includes the operations of American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc. Our non-standard personal automobile insurance generally provides for the minimum limits of liability coverage mandated by state laws to drivers who find it difficult to purchase automobile insurance from standard carriers as a result of

various factors, including driving record, vehicle, age, claims history, or limited financial resources. Products offered by our Phoenix Operating Unit include the following:

- Personal automobile liability.

  Personal automobile liability insurance provides coverage primarily at the minimum limits required by law for automobile liability exposures, including bodily injury and property damage, arising from accidents involving the insured.

- Personal automobile physical damage.

Personal automobile physical damage insurance provides collision and comprehensive coverage for physical damage exposure to the insured vehicle as a result of an accident with another vehicle or object or as a result of causes other than collision such as vandalism, theft, wind, hail or water.

Our Phoenix Operating Unit markets its non-standard personal automobile policies through approximately 1,155 independent agents operating in its target geographic markets. Subject to certain criteria, our Phoenix Operating Unit seeks to maximize the number of agents appointed in each geographic area in order to more effectively penetrate its highly competitive markets. However, our Phoenix Operating Unit periodically evaluates its independent agents and discontinues the appointment of agents whose production history does not satisfy certain standards. During the year ended December 31, 2006, the top ten independent agency groups produced 18%, and no individual agency group produced more than 3%, of the total premium volume of our Phoenix Operating Unit.

During 2006, personal automobile liability coverage accounted for 78% and personal automobile physical damage coverage accounted for 22% of the total premiums produced by our Phoenix Operating Unit. Phoenix General Agency currently offers one-, two-, three-, six- and twelve-month policies. Our typical non-standard personal automobile customer is unable or unwilling to pay a full or half year's premium in advance. Accordingly, we currently offer a direct bill program where the premiums are directly billed to the insured on a monthly basis. We charge an installment fee between $3.00 and $9.00 per payment under the direct bill program.

Our Phoenix Operating Unit markets non-standard personal automobile policies in Arizona, New Mexico, Oklahoma, Arkansas, Idaho, Oregon and Washington directly for PIIC. In Texas, our Phoenix Operating Unit markets non-standard personal automobile policies both through reinsurance arrangements with unaffiliated companies and, since the fourth quarter of 2005, directly for PIIC. Since October 1, 2003, we have provided non-standard personal automobile coverage in Texas through a reinsurance arrangement with Old American County Mutual Fire Insurance Company ("OACM"). Phoenix General Agency holds a managing general agency appointment from OACM to manage the sale and servicing of OACM policies. Effective October 1, 2004, AHIC reinsures 100% of the OACM policies produced by Phoenix General Agency under these reinsurance arrangements. Prior to October 1, 2004, AHIC reinsured 45% of the OACM policies produced by Phoenix General Agency.

Our Competitive Strengths

We believe that we enjoy the following competitive strengths:

- Specialized market knowledge and underwriting expertise.

  All of our operating units possess extensive knowledge of the specialty and niche markets in which they operate, which we believe allows them to effectively structure and market their property/casualty insurance products. Our Phoenix Operating Unit has a thorough understanding of the unique characteristics of the non-standard personal automobile market. Our HGA Operating Unit has significant underwriting experience in its target markets for standard commercial property/casualty insurance products. In addition, our TGA

Operating Unit and Aerospace Operating Unit have developed specialized underwriting expertise which enhances their ability to profitably underwrite non-standard property/casualty insurance coverages.

- Tailored market strategies.

  Each of our operating units has developed its own customized strategy for penetrating the specialty or niche markets in which it operates. These strategies include distinctive product structuring, marketing, distribution, underwriting and servicing approaches by each operating unit. As a result, we are able to structure our property/casualty insurance products to serve the unique risk and coverage needs of our insureds. We believe that these market-specific strategies enable us to provide policies tailored to the target customer which are appropriately priced and fit our risk profile.

- Superior agent and customer service.

  We believe that performing the underwriting, billing, customer service and claims management functions at the operating unit level allows us to provide superior service to both our independent agents and insured customers. The easy-to-use interfaces and responsiveness of our operating units enhance their relationships with the independent agents who sell our policies. We also believe that our consistency in offering our insurance products through hard and soft markets helps to build and maintain the loyalty of our independent agents. Our customized products, flexible payment plans and prompt claims processing are similarly beneficial to our insureds.

- Market diversification.

  We believe that operating in various specialty and niche segments of the property/casualty insurance market diversifies both our revenues and our risks. We also believe our operating units generally operate on different market cycles, producing more earnings stability than if we focused entirely on one product. As a result of the pooling arrangement among our insurance company subsidiaries, we are able to allocate our capital among these various specialty and niche markets in response to market conditions and expansion opportunities. We believe that this market diversification reduces our risk profile and enhances our profitability.

- Experienced management team.

Our senior corporate management has an average of over 20 years of insurance experience. In addition, our operating units have strong management teams, with an average of more than 25 years of insurance industry experience for the heads of our operating units and an average of more than 15 years of underwriting experience for our underwriters. Our management has significant experience in all aspects of property/casualty insurance, including underwriting, claims management, actuarial analysis, reinsurance and regulatory compliance. In addition, Hallmark's senior management has a strong track record of acquiring businesses that expand our product offerings and improve our profitability profile.

Our Strategy

We are striving to become a leading diversified property/casualty insurance group offering products in specialty and niche markets through the following strategies:

- Focusing on underwriting discipline and operational efficiency.

We seek to consistently generate an underwriting profit on the business we write in hard and soft markets. Our operating units have a strong track record of underwriting discipline and operational efficiency which we seek to continue. We believe that in soft markets our competitors often offer policies at a low or negative underwriting profit

in order to maintain or increase their premium volume and market share. In contrast, we seek to write business based on its profitability rather than focusing solely on premium production. To that end, we provide financial incentives to many of our underwriters and independent agents based on underwriting profitability.

- Increasing the retention of business written by our operating units.

Our operating units have a strong track record of writing profitable business in their target markets. Historically, the majority of those premiums were retained by unaffiliated insurers. During 2005, we increased the capital of our insurance company subsidiaries which has enabled us to retain significantly more of the premiums our operating units produce. We expect to continue to increase the portion of our premium production retained by our insurance company subsidiaries. We believe that the underwriting profit earned from this newly retained business will drive our profitability growth in the near-term.

- Achieving organic growth in our existing business lines.

We believe that we can achieve organic growth in our existing business lines by consistently providing our insurance products through market cycles, expanding geographically, expanding our agency relationships and further penetrating our existing customer base. We believe that our extensive market knowledge and strong agency relationships position us to compete effectively in our various specialty and niche markets. We also believe there is a significant opportunity to expand some of our existing business lines into new geographical areas and through new agency relationships while maintaining our underwriting discipline and operational efficiency. In addition, we believe there is an opportunity for some of our operating units to further penetrate their existing customer bases with additional products offered by other operating units.

- Pursuing selected, opportunistic acquisitions.

We seek to opportunistically acquire insurance organizations that operate in specialty or niche property/casualty insurance markets that are complementary to our existing operations. We seek to acquire companies with experienced management teams, stable loss results and strong track records of underwriting profitability and operational efficiency. Where appropriate, we intend to ultimately retain profitable business produced by the acquired companies that would otherwise be retained by unaffiliated insurers. Our management has significant experience in evaluating potential acquisition targets, structuring transactions to ensure continued success and integrating acquired companies into our operational structure.

Distribution

We market our property/casualty insurance products solely through independent general agents, retail agents and specialty brokers. Therefore, our relationships with independent agents and brokers are critical to our ability to identify, attract and retain profitable business. Each of our operating units has developed its own tailored approach to establishing and maintaining its relationships with these independent distributors of our products. These strategies focus on providing excellent service to our agents and brokers, maintaining a consistent presence in our target niche and specialty markets through hard and soft market cycles and fairly compensating the agents and brokers who market our products. Our operating units also regularly evaluate independent general and retail agents based on the underwriting profitability of the business they produce and their performance in relation to our objectives.

Except for the products of our Aerospace Operating Unit, the distribution of property/casualty insurance products by our business segments is geographically concentrated. For the twelve months ended December 31, 2006, five states accounted for 88.5% of the gross premiums retained by our insurance subsidiaries. The following table reflects the geographic distribution of our insured risks, as represented by direct and assumed premiums written by our business segments for the twelve months ended December 31, 2006.

State	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Total	Percent of Total
	Direct and Assumed Premiums Written				
	(dollars in thousands)				
Texas	$ 23,370	$ 60,168	$ 21,265	$ 104,803	49.0%
Oregon	33,016	303	-	33,319	15.6%
New Mexico	14,913	158	8,101	23,172	10.8%
Idaho	14,577	208	1,342	16,127	7.5%
Arizona	-	577	11,338	11,915	5.6%
All other states	5,194	16,326	3,089	24,609	11.5%
Total gross premiums written	$ 91,070	$ 77,740	$ 45,135	$ 213,945	
Percent of total	42.6%	36.3%	21.1%	100.0%	

Underwriting

The underwriting process employed by our operating units involves securing an adequate level of underwriting information, identifying and evaluating risk exposures and then pricing the risks we choose to accept. Each of our operating units offering commercial or aviation insurance products employs its own underwriters with in-depth knowledge of the specific niche and specialty markets targeted by that operating unit. We employ a disciplined underwriting approach that seeks to provide policies appropriately tailored to the specified risks and to adopt pricing structures that will be supported in the applicable market. Our experienced commercial and aviation underwriters have developed underwriting principles and processes appropriate to the coverages offered by their respective operating units.

We believe that managing the underwriting process through our operating units capitalizes on the knowledge and expertise of their personnel in specific markets and results in better underwriting decisions. All of our underwriters have established limits of underwriting authority based on their level of experience. We also provide financial incentives to many of our underwriters based on underwriting profitability.

To better diversify our revenue sources and manage our risk, we seek to maintain an appropriate business mix among our operating units. At the beginning of each year, we establish a target net loss ratio for each operating unit. We then monitor the actual net loss ratio on a monthly basis. If any line of business fails to meet its target net loss ratio, we seek input from our underwriting, actuarial and claims management personnel to develop a corrective action plan. Depending on the particular circumstances, that plan may involve tightening underwriting guidelines, increasing rates, modifying product structure, re-evaluating independent agency relationships or discontinuing unprofitable coverages or classes of risk.

An insurance company's underwriting performance is traditionally measured by its statutory loss and loss adjustment expense ratio, its statutory expense ratio and its statutory combined ratio. The statutory loss and loss adjustment expense ratio, which is calculated as the ratio of net losses and loss adjustment expenses incurred to net premiums earned, helps to assess the adequacy of the insurer's rates, the propriety of its underwriting guidelines and the performance of its claims department. The statutory expense ratio, which is calculated as the ratio of underwriting and operating expenses to net premiums written, assists in measuring the insurer's cost of processing and managing the business. The statutory combined ratio, which is the sum of the statutory loss and loss adjustment expense ratio and the statutory expense ratio, is indicative of the overall profitability of an insurer's underwriting activities, with a

combined ratio of less than 100% indicating profitable underwriting results.

The following table shows, for the periods indicated, (i) our gross premiums written (in thousands); and (ii) our underwriting results as measured by the net statutory loss and loss adjustment expense ratio, the statutory expense ratio, and the statutory combined ratio.

	Year Ended December 31,		
	2006	2005	2004
Gross premiums written	$ 213,945	$ 89,467	$ 33,389
Statutory loss & LAE ratio	61.5%	60.3%	60.5%
Statutory expense ratio	29.4%	32.8%	28.3%
Statutory combined ratio	90.9%	93.1%	88.8%

Our GSIC insurance company subsidiary was acquired effective January 1, 2006 and, therefore, is not included in the statutory ratios for 2005 or 2004. These statutory ratios do not reflect the deferral of policy acquisition costs, investment income, premium finance revenues, or the elimination of inter-company transactions required by GAAP. The increase in the statutory expense ratio in 2005 was driven primarily by the assumption of commercial premiums from Clarendon.

Under Texas Department of Insurance, Arizona Department of Insurance and Oklahoma Insurance Department guidelines, property/casualty insurance companies are expected to maintain a premium-to-surplus percentage of not more than 300%. The premium-to-surplus percentage measures the relationship between net premiums written in a given period (premiums written, less returned premiums and reinsurance ceded to other carriers) to policyholders surplus (admitted assets less liabilities), determined on the basis of statutory accounting practices prescribed or permitted by insurance regulatory authorities. For the years ended December 31, 2006, 2005, and 2004, AHIC's statutory premium-to-surplus percentages were 111%, 94% and 121%, respectively. PIIC's statutory premium-to-surplus percentages were 202%, 79% and 139% for the years ended December 31, 2006, 2005 and 2004, respectively. GSIC

's statutory premium-to-surplus percentage for the year ended December 31, 2006 was 196%. The decline in premium-to-surplus percentages for AHIC and PIIC in 2005 reflect the added underwriting capacity attributable to the increased surplus from profitable operations and our 2005 capital plan. The increase in premium-to-surplus percentages for AHIC and PIIC in 2006 reflect additional retention of premiums produced by the Standard Commercial Segment and Specialty Commercial Segment, as well as increased premiums written in the Personal Segment.

Claims Management and Administration

We believe that effective claims management is critical to our success and that our claims management process is cost-effective, delivers the appropriate level of claims service and produces superior claims results. Our claims management philosophy emphasizes the delivery of courteous, prompt and effective claims handling and embraces responsiveness to policyholders and agents. Our claims strategy focuses on thorough investigation, timely evaluation and fair settlement of covered claims while consistently maintaining appropriate case reserves. We seek to compress the cycle time of claim resolution in order to control both loss and claim handling cost. We also strive to control legal expenses by negotiating competitive rates with defense counsel and vendors, establishing litigation budgets and monitoring invoices.

Each of our operating units uses its own staff of specialized claims personnel to manage and administer claims arising under policies produced through their respective operations. The claims process is managed through a combination of experienced claims managers, seasoned claims supervisors, trained staff adjusters and independent adjustment or

appraisal services, when appropriate. All adjusters are licensed in those jurisdictions for which they handle claims that require licensing. Limits on settlement authority are established for each claims supervisor and staff adjuster based on their level of experience. Independent adjusters have no claim settlement authority. Claim exposures are periodically and systematically reviewed by claim supervisors and managers as a method of quality and loss control. Large loss exposures are reviewed at least quarterly with senior management of the operating unit and monitored by Hallmark senior management.

Claims personnel receive in-house training and are required to attend various continuing education courses pertaining to topics such as best practices, fraud awareness, legal environment, legislative changes and litigation management. Depending on the criteria of each operating unit, our claims adjusters are assigned a variety of claims to enhance their knowledge and ensure their continued development in efficiently handling claims. As of December 31, 2006, our operating units had a total of 46 claims managers, supervisors and adjusters with an average of approximately 18 years experience.

Analysis of Losses and LAE

Our consolidated financial statements include an estimated reserve for unpaid losses and loss adjustment expenses. We estimate our reserve for unpaid losses and loss adjustment expenses by using case-basis evaluations and statistical projections, which include inferences from both losses paid and losses incurred. We also use recent historical cost data and periodic reviews of underwriting standards and claims management practices to modify the statistical projections. We give consideration to the impact of inflation in determining our loss reserves, but do not discount reserve balances.

The amount of reserves represents our estimate of the ultimate net cost of all unpaid losses and loss adjustment expenses incurred. These estimates are subject to the effect of trends in claim severity and frequency. We regularly review the estimates and adjust them as claims experience develops and new information becomes known. Such adjustments are included in current operations, including increases and decreases, net of reinsurance, in the estimate of ultimate liabilities for insured events of prior years.

Changes in loss development patterns and claim payments can significantly affect the ability of insurers to estimate reserves for unpaid losses and related expenses. We seek to continually improve our loss estimation process by refining our ability to analyze loss development patterns, claim payments and other information within a legal and regulatory environment which affects development of ultimate liabilities. Future changes in estimates of claim costs may adversely affect future period operating results. However, such effects cannot be reasonably estimated currently.

Reconciliation of reserve for unpaid losses and LAE

. The following table provides a reconciliation of our beginning and ending reserve balances on a net-of-reinsurance basis for the years ended December 31, 2006, 2005 and 2004, to the gross-of-reinsurance amounts reported in our balance sheets at December 31, 2006, 2005 and 2004.

	As of and for Year Ended December 31,
	2006
	2005
	2004

(dollars in thousands)

Reserve for unpaid losses and LAE, net of reinsurance recoverables, January 1	$ 25,997	$ 17,700	$ 21,197
Acquisitions of subsidiaries effective January 1	4,562	-	-
Provision for losses and LAE for claims occurring in the current period	88,294	36,184	20,331
Increase (decrease) in reserve for unpaid losses and LAE for claims occurring in prior periods	(1,177)	(2,400)	(1,194)
Payments for losses and LAE, net of reinsurance:			
Current period	(28,154)	(17,414)	(10,417)
Prior periods			

	(16,721)	(8,073)	(12,217)
Reserve for unpaid losses and LAE at December 31, net of reinsurance recoverable	72,801	25,997	17,700
Reinsurance recoverable on unpaid losses and LAE at December 31	4,763	324	1,948
Reserve for unpaid losses and LAE at December 31, gross of reinsurance	$ 77,564	$ 26,321	$ 19,648

The $1.2 million, $2.4 million and $1.2 million favorable development in prior accident years recognized in 2006, 2005 and 2004, respectively, represent normal changes in our loss reserve estimates primarily attributable to favorable loss development in the Personal Segment for accident years 2002 through 2004. At the time these loss reserves were initially established, new management was in the process of implementing operational changes designed to improve operating results. These operational changes included the cancellation of relationships with agents producing unprofitable business, a shift in marketing focus to direct bill policies, increases in policy rates and using our own personnel and processes to settle claims on policies issued by PIIC rather than using an outside claims adjustment vendor. However, the effectiveness of these operational changes could not be accurately predicted at that time. As

additional data emerged, it became increasingly clear that the actual results from these operational enhancements were developing more favorably than originally projected. Therefore, the loss reserve estimates for these prior years were decreased to reflect this favorable loss development when the available information indicated a reasonable likelihood that the ultimate losses would be less than the previous estimates.

SAP/GAAP reserve reconciliation.

The differences between the reserves for unpaid losses and loss adjustment expenses reported in our consolidated financial statements prepared in accordance with GAAP and those reported in our annual statements filed with the Texas Department of Insurance, the Arizona Department of Insurance and the Oklahoma Insurance Department in accordance with statutory accounting practices as of December 31, 2006 and 2005 are summarized below.

	As of December 31,			
	2006		2005	
	(in thousands)			
Reserve for unpaid losses and LAE on a SAP basis (net of reinsurance recoverables on unpaid losses)	$	72,796	$	24,580
Loss reserve discount from the PIIC acquisition		(11)		(35)
Unamortized risk premium reserve discount from the PIIC acquisition		16		49
Estimated future unallocated LAE reserve for claim service subsidiaries		-		1,403
Reserve for unpaid losses and LAE on a GAAP basis (net of reinsurance recoverables on unpaid losses)	$	72,801	$	25,997

Our reserve for estimated future unallocated losses and loss adjustment expenses was moved to our insurance company subsidiaries in 2006 and therefore, there was no difference in the amount reported under statutory accounting practices and GAAP as of December 31, 2006.

Analysis of loss and LAE reserve development.

The following table shows the development of our loss reserves, net of reinsurance, for years ended December 31, 1996 through 2006. Section A of the table shows the estimated liability for unpaid losses and loss adjustment expenses, net of reinsurance, recorded at the balance sheet date for each of the indicated years. This liability represents the estimated amount of losses and loss adjustment expenses for claims arising in prior years that are unpaid at the balance sheet date, including losses that have been incurred but not yet reported to us. Section B of the table shows the re-estimated amount of the previously recorded liability, based on experience as of the end of each succeeding year. The estimate is increased or decreased as more information becomes known about the frequency and severity of claims.

Cumulative Redundancy/Deficiency (Section C of the table) represents the aggregate change in the estimates over all prior years. Thus, changes in ultimate development estimates are included in operations over a number of years, minimizing the significance of such changes in any one year.

ANALYSIS OF LOSS AND LAE DEVELOPMENT
As of and for Year Ended December 31

1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
(dollars in thousands)										

A. Reserve for Unpaid Losses & LAE, Net of Reinsurance Recoverables	$5,096	$4,668	$4,580	$5,409	$7,451	$7,919	$8,411	$21,197	$17,700	$25,997	$72,801
B. Net Reserve Re-estimated as of :											
One year later	6,227	4,985	4,594	5,506	7,974	8,096	8,875	20,003	15,300	24,820	
Two years later	6,162	4,954	4,464	5,277	7,863	8,620	8,881	19,065	15,473		
Three years later	6,117	4,884	4,225	5,216	7,773	8,856	8,508	19,698			
Four years later	6,070	4,757	4,179	5,095	7,901	8,860	8,446				
Five years later	5,954	4,732	4,111	5,028	7,997	8,855					
Six years later	5,928	4,687	4,101	5,153	7,999						
Seven years later	5,900	4,695	4,209	5,153							
Eight years later	5,902	4,675	4,203								
Nine years later	5,881	4,674									
Ten years later	5,881										
C. Net Cumulative Redundancy (Deficiency)	(785)	(6)	377	256	(548)	(936)	(35)	1,499	2,227	1,177	
D. Cumulative Amount of Claims Paid, Net of Reinsurance Recoveries, through:											
One year later	4,326	3,326	2,791	3,229	5,377	5,691	5,845	12,217	8,073	16,721	
Two years later	5,528	4,287	3,476	4,436	7,070	7,905	7,663	15,814	12,004		
Three years later	5,860	4,387	3,911	4,909	7,584	8,603	8,228	18,162			
Four years later	5,699	4,571	4,002	5,014	7,810	8,798	8,374				
Five years later	5,818	4,618	4,051	4,966	7,960	8,821					
Six years later	5,853	4,643	4,061	5,116	7,970						
Seven years later	5,860	4,664	4,204	5,124							
Eight years later	5,871	4,675	4,203								
Nine years later	5,881	4,674									
Ten years later	5,881										

	2006	2005
Net Reserve, December 31	$72,801	$25,997
Reinsurance Recoverables	4,763	324
Gross Reserve, December 31	$77,564	$26,321
Net Re-estimated Reserve		24,820
Re-estimated Reinsurance Recoverable		804

Gross Re-estimated Reserve	$ 25,624
Gross Cumulative Redundancy	$ 697

Reinsurance

We reinsure a portion of the risk we underwrite in order to control our exposure to losses and to protect our capital resources. We cede to reinsurers a portion of these risks and pay premiums based upon the risk and exposure of the policies subject to such reinsurance. Ceded reinsurance involves credit risk and is generally subject to aggregate loss limits. Although the reinsurer is liable to us to the extent of the reinsurance ceded, we are ultimately liable as the direct insurer on all risks reinsured. Reinsurance recoverables are reported after allowances for uncollectible amounts. We monitor the financial condition of reinsurers on an ongoing basis and review our reinsurance arrangements periodically. Reinsurers are selected based on their financial condition, business practices and the price of their product offerings. Our reinsurance facilities are subject to annual renewal.

Effective October 1, 2003, we assumed the reinsurance of 45% of the Texas non-standard automobile policies produced by our Phoenix Operating Unit and underwritten by OACM. During this period, the remaining 55% of each policy was directly assumed by Dorinco Reinsurance Company ("Dorinco"). Under these reinsurance arrangements, we are obligated to policyholders only for the portion of the risk that we assumed. Since October 1, 2004, we have assumed and retained the reinsurance of 100% of the Texas non-standard personal automobile policies produced by our Phoenix Operating Unit and underwritten by OACM.

Under our prior insurance arrangements with Dorinco, we earned ceding commissions based on loss ratio experience on the portion of policies reinsured by Dorinco. We received a provisional commission as policies were produced as an advance against the later determination of the commission actually earned. The provisional commission is adjusted periodically on a sliding scale based on expected loss ratios. As of December 31, 2006 and 2005, the accrued ceding commission payable to Dorinco was $0.4 million and $0.4 million, respectively. This accrual represents the difference between the provisional ceding commission received and the ceding commission earned based on current loss ratios.

The following table presents our gross and net premiums written and earned and reinsurance recoveries for each of the last three years.

	Year Ended December 31,		
	2006	2005	2004
Gross premiums written	$ 213,945	$ 89,467	$ 33,389
Ceded premiums written	(11,017)	(1,215)	(322)
Net premiums written	$ 202,928	$ 88,252	$ 33,067
Gross premiums earned	$ 162,216	$ 59,632	$ 33,058
Ceded premiums earned	(10,155)	(448)	(613)
Net premiums earned	$ 152,061	$ 59,184	$ 32,445
Reinsurance recoveries	$ 5,669	$ (492)	$ 163

Our insurance company subsidiaries presently retain 100% of the risk associated with all non-standard personal

automobile policies marketed by our Phoenix Operating Unit. We currently reinsure the following exposures on business generated by our HGA Operating Unit, our TGA Operating Unit and our Aerospace Operating Unit:

- Property catastrophe.

  Our property catastrophe reinsurance reduces the financial impact a catastrophe could have on our commercial property insurance lines. Catastrophes might include multiple claims and policyholders. Catastrophes include hurricanes, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Our property catastrophe reinsurance is excess-of-loss reinsurance, which provides us reinsurance coverage for losses in excess of an agreed-upon amount. We utilize catastrophe models to assist in determining appropriate retention and limits to purchase. The terms of our property catastrophe reinsurance, effective July 1, 2006, are:

  - ♦ We retain the first $1.0 million of property catastrophe losses; and
  - ♦ Our reinsurers reimburse us 100% for each $1.00 of loss in excess of our $1.0 million retention up to $20.0 million for each catastrophic occurrence, subject to a maximum of two events for the contractual term.

- Commercial property.

  Our commercial property reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event or catastrophic loss may have on our results. The terms of our commercial property reinsurance, effective July 1, 2006, are:

  - ♦ We retain the first $500,000 of loss for each commercial property risk;
  - ♦ Our reinsurers reimburse us for the next $4.5 million for each commercial property risk; and
  - ♦ Individual risk facultative reinsurance is purchased on any commercial property with limits above $5 million.

- Commercial umbrella.

  Our commercial umbrella reinsurance reduces the financial impact of losses in this line of business. Our commercial umbrella reinsurance is quota-share reinsurance, in which the reinsurers share a proportional amount of the premiums and losses. Under our current commercial umbrella reinsurance, effective July 1, 2006, we retain 10% of the premiums and losses and cede 90% to our reinsurers.

- Commercial casualty.

  Our commercial casualty reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event loss may have on our results. We have separate commercial casualty reinsurance policies for the business written by our HGA Operating Unit and our TGA Operating Unit. The terms of our commercial casualty reinsurance for our HGA Operating Unit, effective July 1, 2006, are:

  - ♦ We retain the first $500,000 of any commercial liability loss, including commercial automobile liability; and
  - ♦ Our reinsurers reimburse us for the next $500,000 for each commercial liability loss, including commercial automobile liability.

  The terms of our commercial casualty reinsurance for our TGA Operating Unit, effective January 1, 2006, are:

  - ♦ We retain the first $250,000 of any commercial liability loss, including commercial automobile liability; and

♦ Our reinsurers reimburse us for the next $250,000 for each commercial liability loss, including commercial automobile liability.

- Aviation.

We purchase reinsurance specific to the aviation risks underwritten by our Aerospace Operating Unit. This reinsurance provides aircraft hull and liability coverage and airport liability coverage on a per occurrence basis on the following terms:

♦ We retain the first $350,000 of each aircraft hull or liability loss or airport liability loss;

♦ Our reinsurers reimburse us for the next $1.15 million of each aircraft hull or liability loss and for the next $650,000 of each airport liability loss; and

♦ Our reinsurers provide additional reimbursement of $4.0 million for each airport liability loss and aircraft liability loss, excluding passenger liability.

Investment Portfolio

Our investment objective is to maximize current yield while maintaining safety of capital together with sufficient liquidity for ongoing insurance operations. Our investment portfolio is composed of fixed-income and equity securities. As of December 31, 2006, we had total invested assets of $162.9 million, of which $7.2 million was classified as restricted investments. If market rates were to increase by 1%, the fair value of our fixed-income securities as of December 31, 2006 would decrease by approximately $3.9 million. The following table shows the fair values of various categories of fixed-income securities, the percentage of the total fair value of our invested assets represented by each category and the tax equivalent book yield based on fair value of each category of invested assets as of December 31, 2005 and 2006.

As of December 31, 2006

As of December 31, 2005

Fair

Percent of

Fair

Percent of

Value

Total

Yield

Value

Total

Yield

(in thousands)

(in thousands)

Category

Corporate bonds

40,483

25.6%

6.6%

54,434

54.7%

3.5%

Municipal bonds

52,132

32.9%

3.8%

28,646

28.8%

4.3%

US Treasury bonds

40,407

25.5%

4.0%

	4,178	4.2%	3.7%			
US Treasury bills and other short-term	25,275	16.0%	3.8%	12,281	12.3%	0.9%
Mortgage backed securities	8	0.0%	7.6%	14	0.0%	9.4%
Total	$ 158,305	100.0%	4.6%	$ 99,553		

100.0%

3.4%

The average credit rating for our fixed-income portfolio, using ratings assigned by Standard and Poor's Rating Services (a division of the McGraw-Hill Companies, Inc.), was A+ at December 31, 2006. The following table shows the distribution of our fixed-income portfolio by Standard and Poor's rating as a percentage of total market value as of December 31, 2006 and 2005:

	As of December 31, 2006	As of December 31, 2005
Rating:		
"AAA"	68.5%	44.1%
"AA"	6.4%	7.2%
"A"	3.4%	10.4%
"BBB"	11.6%	17.7%
"BB"	8.8%	16.7%
"B"	1.3%	1.0%
"CCC"	0.0%	2.9%
Total	100.0%	100.0%

The following table shows the composition of our fixed-income portfolio by remaining time to maturity as of December 31, 2006 and 2005.

	As of December 31, 2006		As of December 31, 2005	
	Fair Value	Percentage of Total Fair Value	Fair Value	Percentage of Total Fair Value
	(in thousands)		(in thousands)	
Remaining time to maturity:				
Less than one year	67,060	42.4%	25,158	25.3%
One to five years	44,018	27.8%	27,810	27.9%
Five to ten years	42,616	26.9%	43,370	43.6%
More than ten years	4,603	2.9%	3,201	3.2%
Mortgage-backed securities	8	0.0%	14	0.0%
Total	158,305	100.0%	99,553	100.0%

Our investment strategy is to conservatively manage our investment portfolio by investing primarily in readily marketable, investment-grade fixed-income securities. As of December 31, 2006, 2.8% of our investment portfolio was invested in common equity securities. Our investment portfolio is managed internally. We regularly review our portfolio for declines in value. If a decline in value is deemed temporary, we record the decline as an unrealized loss in other comprehensive income on our consolidated statement of income and accumulated other comprehensive income on our consolidated balance sheet. If the decline is deemed other than temporary, we write down the carrying value of the investment and record a realized loss in our consolidated statements of income. As of December 31, 2006, we had a net unrealized loss of $0.5 million on our investments. The following table details the net unrealized loss (gain) balance by invested asset category as of December 31, 2006.

Category	Net Unrealized Loss (Gain) Balance
	(in thousands)
Corporate bonds	$ 805
Municipal bonds	112
Equity securities	(434)
US Treasury securities	(7)
Total	$ 476

As part of our overall investment strategy, we also maintain an integrated cash management system utilizing on-line banking services and daily overnight investment accounts to maximize investment earnings on all available cash.

Technology

The majority of our technology systems are based on products licensed from insurance-specific technology vendors which have been substantially customized to meet the unique needs of our various operating units. Our technology systems primarily consist of integrated central processing computers, a series of server-based computer networks and various communications systems that allow our branch offices to share systems solutions and communicate to the home office in a timely, secure and consistent manner. We maintain backup facilities and systems through a contract with a leading provider of computer disaster recovery services. Each operating unit bears the information services expenses specific to its operations as well as a portion of the corporate services expenses. Vendor license and service fees are capped per annum and are not directly tied to premium volume or geographic expansion.

We believe the implementation of our various technology systems has increased our efficiency in the processing of our business, resulting in lower operating costs. Additionally, our systems enable us to provide a high level of service to our agents and policyholders by processing our business in a timely and efficient manner, communicating and sharing data with our agents and providing a variety of methods for the payment of premiums. We believe these systems have also improved the accumulation and analysis of information for our management.

Ratings

Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they are considering purchasing insurance. As of June 5, 2006, A.M. Best pooled its ratings of our three insurance company subsidiaries and assigned a financial strength rating of "A-" (Excellent) and an issuer credit rating of "a-" to each of our individual insurance company subsidiaries and to the pool formed by our insurance company subsidiaries. An "A-" rating is the fourth highest of 15 rating categories used by A.M. Best. In evaluating an insurer's financial and operating performance, A.M. Best reviews the company's profitability, indebtedness and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market valueof its assets, the adequacy of its loss reserves, the adequacy of its surplus, its capital structure, the experience and competence of its management and its market presence. A.M. Best's ratings reflect its opinion of an insurer's financial strength, operating performance and ability to meet its obligations to policyholders and are not an evaluation directed at investors or recommendations to buy, sell or hold an insurer's stock.

Competition

The property/casualty insurance market, our primary source of revenue, is highly competitive and, except for regulatory considerations, has very few barriers to entry. According to A.M. Best, there were 3,173 property/casualty insurance companies and 2,065 property/casualty insurance groups operating in North America as of July 24, 2006. Our HGA Operating Unit competes with a variety of large national standard commercial lines carriers such as The Hartford, Zurich North America, St. Paul Travelers and Safeco, as well as numerous smaller regional companies. The primary competition for our TGA Operating Unit's excess and surplus lines products includes such carriers as Atlantic Casualty Insurance Company, Colony Insurance Company, Burlington Insurance Company, Penn America Insurance Group and, to a lesser extent, a number of national standard lines carriers such as Zurich North America and The Hartford. Our Aerospace Operating Unit considers its primary competitors to be Houston Casualty Corp., Phoenix Aviation, W. Brown & Company, AIG and London Aviation Underwriters. Although our Phoenix Operating Unit competes with large national insurers such as Allstate, State Farm and Progressive, as a participant in the non-standard personal automobile marketplace its competition is most directly associated with numerous regional companies and managing general agencies. Our competitors include entities which have, or are affiliated with entities which have, greater financial and other resources than we have.

Generally, we compete on price, customer service, coverages offered, claims handling, financial stability, agent commission and support, customer recognition and geographic coverage. We compete with companies who use independent agents, captive agent networks, direct marketing channels or a combination thereof.

Insurance Regulation

Our insurance operations are regulated by the Texas Department of Insurance, the Arizona Department of Insurance and the Oklahoma Insurance Department, as well as the applicable insurance department of each state in which we issue policies. AHIC, PIIC and GSIC are required to file quarterly and annual statements of their financial condition prepared in accordance with statutory accounting practices with the Texas Department of Insurance, the Arizona Department of Insurance and the Oklahoma Insurance Department, respectively, and the applicable insurance department of each state in which they write business. The financial conditions of AHIC, PIIC and GSIC, including the adequacy of surplus, loss reserves and investments, are subject to review by the insurance department of their respective states of domicile. We do not write the majority of our Texas non-standard personal automobile insurance directly, but assume business written through a county mutual insurance company. Under Texas insurance regulation, premium rates and underwriting guidelines of county mutuals have historically not been subject to the same degree of regulation imposed on standard insurance companies.

Periodic financial and market conduct examinations.

The Texas Department of Insurance, the Arizona Department of Insurance and the Oklahoma Insurance Department have broad authority to enforce insurance laws and regulations through examinations, administrative orders, civil and criminal enforcement proceedings, and suspension or revocation of an insurer's certificate of authority or an agent's license. The state insurance departments that have jurisdiction over our insurance company subsidiaries may conduct on-site visits and examinations of the insurance companies' affairs, especially as to their financial condition, ability to fulfill their obligations to policyholders, market conduct, claims practices and compliance with other laws and applicable regulations. Typically, these examinations are conducted every three to five years. In addition, if circumstances dictate, regulators are authorized to conduct special or target examinations of insurance companies to address particular concerns or issues. The results of these examinations can give rise to regulatory orders requiring remedial, injunctive or other corrective action on the part of the company that is the subject of the examination, assessment of fines or other penalties against that company. In extreme cases, including actual or pending insolvency, the insurance department may take over, or appoint a receiver to take over, the management or operations of an insurer or an agent's business or assets.

Guaranty funds.

All insurance companies are subject to assessments for state-administered funds which cover the claims and expenses of insolvent or impaired insurers. The size of the assessment is determined each year by the total claims on the fund that year. Each insurer is assessed a pro rata share based on its direct premiums written in that state. Payments to the fund may be recovered by the insurer through deductions from its premium taxes over a specified period of years.

Transactions between insurance companies and their affiliates

. Hallmark is also regulated as an insurance holding company by the Texas Department of Insurance, the Arizona Department of Insurance and the Oklahoma Insurance Department. Financial transactions between Hallmark or any of its affiliates and AHIC, PIIC or GSIC are subject to regulation. Transactions between our insurance company subsidiaries and their affiliates generally must be disclosed to state regulators, and prior regulatory approval generally is required before any material or extraordinary transaction may be consummated or any management agreement, services agreement, expense sharing arrangement or other contract providing for the rendering of services on a regular, systematic basis is implemented. State regulators may refuse to approve, or may delay approval of such a transaction, which may impact our ability to innovate or operate efficiently.

Dividends.

Dividends and distributions to Hallmark by AHIC, PIIC or GSIC are restricted by the insurance regulations of the respective state in which each insurance company subsidiary is domiciled. As a property/casualty insurance company domiciled in the State of Texas, AHIC is limited in the payment of dividends to the amount of surplus profits arising from its business. In estimating such profits, AHIC must exclude all unexpired risks, all unpaid losses and all other debts due and payable or to become due and payable by AHIC. In addition, AHIC must obtain the approval of the Texas Department of Insurance before the payment of extraordinary dividends, which are defined as dividends or distributions of cash or other property the fair market value of which combined with the fair market value of each other dividend or distribution made in the preceding 12 months exceeds the greater of: (1) statutory net income as of the prior December 31st or (2) 10% of statutory policyholders' surplus as of the prior December 31st. PIIC, domiciled in Arizona, may pay dividends out of that part of its available surplus funds which is derived from realized net profits on its business. Without prior written approval from the Arizona Department of Insurance, PIIC may not pay extraordinary dividends, which are defined as dividends or distributions of cash or other property the fair market value of which combined with the fair market value of each other dividend or distribution made in the preceding 12 months exceeds the lesser of: (1) 10% of statutory policyholders' surplus as of the prior December 31st or (2) net investment income as of the prior December 31st. GSIC, domiciled in Oklahoma, may only pay dividends out of that part of its available surplus funds which is derived from realized net profits on its business. Without prior written approval from the Oklahoma Insurance Department, GSIC may not pay extraordinary dividends, which are defined as dividends or distributions of cash or other property the fair market value of which combined with the fair market value of each other dividend or distribution made in the preceding 12 months exceeds the greater of: (1) 10% of statutory policyholders' surplus as of the prior December 31st or (2) statutory net income as of the prior December 31st, not including realized capital gains.

Risk-based capital requirements.

The National Association of Insurance Commissioners requires property/casualty insurers to file a risk-based capital calculation according to a specified formula. The purpose of the formula is twofold: (1) to assess the adequacy of an insurer's statutory capital and surplus based upon a variety of factors such as potential risks related to investment portfolio, ceded reinsurance and product mix; and (2) to assist state regulators under the RBC for Insurers Model Act by providing thresholds at which a state commissioner is authorized and expected to take regulatory action. As of December 31, 2006, the adjusted capital under the risk-based capital calculation of each of our insurance company subsidiaries substantially exceeded the minimum requirements.

Required licensing.

Hallmark General Agency, Texas General Agency, Phoenix General Agency and Aerospace Insurance Managers are each subject to and in compliance with the licensing requirements of the department of insurance in each state in which they produce business. These licenses govern, among other things, the types of insurance coverages, agency and claims services and products that we may offer consumers in these states. Such licenses typically are issued only after we file an appropriate application and satisfy prescribed criteria. Generally, each state requires one officer to maintain an agent license. Claims adjusters employed by us are also subject to the licensing requirements of each state in which they conduct business. Each employed claim adjuster either holds or has applied for the required licenses. Our premium finance subsidiaries are subject to licensing, financial reporting and certain financial requirements imposed by the Texas Department of Insurance, as well as regulations promulgated by the Texas Office of Consumer Credit Commissioner.

Regulation of insurance rates and approval of policy forms

. The insurance laws of most states in which our subsidiaries operate require insurance companies to file insurance rate schedules and insurance policy forms for review and approval. State insurance regulators have broad discretion in judging whether our rates are adequate, not excessive and not unfairly discriminatory and whether our policy forms comply with law. The speed at which we can change our rates depends, in part, on the method by which the applicable state's rating laws are administered. Generally, state insurance regulators have the authority to disapprove our rates or request changes in our rates.

Restrictions on cancellation, non-renewal or withdrawal

. Many states have laws and regulations that limit an insurance company's ability to exit a market. For example, certain states limit an automobile insurance company's ability to cancel or not renew policies. Some states prohibit an insurance company from withdrawing from one or more lines of business in the state, except pursuant to a plan approved by the state insurance department. In some states, this applies to significant reductions in the amount of insurance written, not just to a complete withdrawal. State insurance departments may disapprove a plan that may lead to market disruption.

Investment restrictions

. We are subject to state laws and regulations that require diversification of our investment portfolios and that limit the amount of investments in certain categories. Failure to comply with these laws and regulations would cause non-conforming investments to be treated as non-admitted assets for purposes of measuring statutory surplus and, in some instances, would require divestiture.

Trade practices

. The manner in which we conduct the business of insurance is regulated by state statutes in an effort to prohibit practices that constitute unfair methods of competition or unfair or deceptive acts or practices. Prohibited practices include disseminating false information or advertising; defamation; boycotting, coercion and intimidation; false statements or entries; unfair discrimination; rebating; improper tie-ins with lenders and the extension of credit; failure to maintain proper records; failure to maintain proper complaint handling procedures; and making false statements in connection with insurance applications for the purpose of obtaining a fee, commission or other benefit.

Unfair claims practices.

Generally, insurance companies, adjusting companies and individual claims adjusters are prohibited by state statutes from engaging in unfair claims practices on a flagrant basis or with such frequency to indicate a general business practice. Examples of unfair claims practices include:

- misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;
- failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies;
- failing to adopt and implement reasonable standards for the prompt investigation and settlement of claims arising under insurance policies;
- failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed;

- attempting to settle a claim for less than the amount to which a reasonable person would have believed such person was entitled;

- attempting to settle claims on the basis of an application that was altered without notice to, or knowledge and consent of, the insured;

- compelling insureds to institute suits to recover amounts due under policies by offering substantially less than the amounts ultimately recovered in suits brought by them;

- refusing to pay claims without conducting a reasonable investigation;

- making claim payments to an insured without indicating the coverage under which each payment is being made;

- delaying the investigation or payment of claims by requiring an insured, claimant or the physician of either to submit a preliminary claim report and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information;

- failing, in the case of claim denials or offers of compromise or settlement, to promptly provide a reasonable and accurate explanation of the basis for such actions; and

- not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear.

Employees

As of December 31, 2006, we employed 347 people on a full-time basis. None of our employees are represented by labor unions. We consider our employee relations to be good.

Item 1A. Risk Factors.

Our success depends on our ability to price accurately the risks we underwrite.

Our results of operations and financial condition depend on our ability to underwrite and set premium rates accurately for a wide variety of risks. Adequate rates are necessary to generate premiums sufficient to pay losses, loss settlement expenses and underwriting expenses and to earn a profit. To price our products accurately, we must collect and properly analyze a substantial amount of data; develop, test and apply appropriate pricing techniques; closely monitor and timely recognize changes in trends; and project both severity and frequency of losses with reasonable accuracy. Our ability to undertake these efforts successfully, and as a result price our products accurately, is subject to a number of risks and uncertainties, some of which are outside our control, including:

- the availability of sufficient reliable data and our ability to properly analyze available data;

- the uncertainties that inherently characterize estimates and assumptions;

- our selection and application of appropriate pricing techniques; and

- changes in applicable legal liability standards and in the civil litigation system generally.

Consequently, we could underprice risks, which would adversely affect our profit margins, or we could overprice risks, which could reduce our sales volume and competitiveness. In either case, our profitability could be materially and adversely affected.

Our results may fluctuate as a result of cyclical changes in the property/casualty insurance industry.

Our revenue is primarily attributable to property/casualty insurance, which as an industry is cyclical in nature and has historically been characterized by soft markets followed by hard markets. A soft market is a period of relatively high levels of price competition, less restrictive underwriting standards and generally low premium rates. A hard market is a period of capital shortages resulting in lack of insurance availability, relatively low levels of competition, more selective underwriting of risks and relatively high premium rates. If we find it necessary to reduce premiums or limit premium increases due to competitive pressures on pricing in a softening market, we may experience a reduction in our premiums written and in our profit margins and revenues, which could adversely affect our financial results.

Estimating reserves is inherently uncertain. If our loss reserves are not adequate, it will have an unfavorable impact on our results.

We maintain loss reserves to cover our estimated ultimate liability for unpaid losses and loss adjustment expenses for reported and unreported claims incurred as of the end of each accounting period. Reserves represent management's estimates of what the ultimate settlement and administration of claims will cost and are not reviewed by an independent actuary. These estimates, which generally involve actuarial projections, are based on management's assessment of facts and circumstances then known, as well as estimates of future trends in claim severity and frequency, judicial theories of liability, and other factors. These variables are affected by both internal and external events, such as changes in claims handling procedures, inflation, judicial trends and legislative changes. Many of these factors are not quantifiable. Additionally, there may be a significant lag between the occurrence of an event and the time it is reported to us. The inherent uncertainties of estimating reserves are greater for certain types of liabilities, particularly those in which the various considerations affecting the type of claim are subject to change and in which long periods of time may elapse before a definitive determination of liability is made. Reserve estimates are continually refined in a regular and ongoing process as experience develops and further claims are reported and settled. Adjustments to reserves are reflected in the results of the periods in which such estimates are changed. For example, a 1% change in December 31, 2006 unpaid losses and loss adjustment expenses would have produced a $0.8 million change to pretax earnings. Our gross loss and loss adjustment expense reserves totaled $77.6 million at December 31, 2006. Our loss and loss adjustment expense reserves, net of reinsurance recoverables, were $71.6 million at that date. Because setting reserves is inherently uncertain, there can be no assurance that the current reserves will prove adequate.

Our failure to maintain favorable financial strength ratings could negatively impact our ability to compete successfully.

Third-party rating agencies assess and rate the claims-paying ability of insurers based upon criteria established by the agencies. During 2005, A.M. Best upgraded the financial strength rating of PIIC from "B" (Fair) to "B+" (Very Good) and upgraded the financial strength rating of AHIC from "B" (Fair) to "A-" (Excellent). Our insurance company subsidiaries have historically been rated on an individual basis. However, effective January 1, 2006, our insurance company subsidiaries entered into a pooling arrangement, which was subsequently amended on December 15, 2006, whereby AHIC would retain 46.0% of the net premiums written, PIIC would retain 34.1% of the net premiums written and GSIC would retain 19.9% of the net premiums written. In June 2006, A.M. Best notified us that our insurance company subsidiaries would be rated on a pooled basis and assigned a rating of "A-" (Excellent) to each of our individual insurance company subsidiaries and to the pool formed by our insurance company subsidiaries.

These financial strength ratings are used by policyholders, insurers, reinsurers and insurance and reinsurance intermediaries as an important means of assessing the financial strength and quality of insurers. These ratings are not evaluations directed to potential purchasers of our common stock and are not recommendations to buy, sell or hold our common stock. Our ratings are subject to change at any time and could be revised downward or revoked at the sole discretion of the rating agencies. We believe that the ratings assigned by A.M. Best are an important factor in marketing our products. Our ability to retain our existing business and to attract new business in our insurance

operations depends largely on these ratings. Our failure to maintain our ratings, or any other adverse development with respect to our ratings, could cause our current and future independent agents and insureds to choose to transact their business with more highly rated competitors. If A.M. Best downgrades our ratings or publicly indicates that our ratings are under review, it is likely that we would not be able to compete as effectively with our competitors, and our ability to sell insurance policies could decline. If that happens, our sales and earnings would decrease. For example, many of our agencies and insureds have guidelines that require us to have an A.M. Best financial strength rating of "A-" (Excellent) or higher. A reduction of our A.M. Best rating below "A-" would prevent us from issuing policies to insureds or potential insureds with such ratings requirements. Because lenders and reinsurers will use our A.M. Best ratings as a factor in deciding whether to transact business with us, the failure of our insurance company subsidiaries to maintain their current ratings could dissuade a lender or reinsurance company from conducting business with us or might increase our interest or reinsurance costs. In addition, a ratings downgrade by A.M. Best below "A-" would require us to post collateral in support of our obligations under certain reinsurance agreements pursuant to which we assume business.

The loss of key executives could disrupt our business.

Our success will depend in part upon the continued service of certain key executives. Our success will also depend on our ability to attract and retain additional executives and personnel. We do not have employment agreements with our Chief Executive Officer or any of our executive officers other than employment agreements entered into in connection with the acquisitions of the subsidiaries now comprising our TGA Operating Unit and our Aerospace Operating Unit. The loss of key personnel, or our inability to recruit and retain additional qualified personnel, could cause disruption in our business and could prevent us from fully implementing our business strategies, which could materially and adversely affect our business, growth and profitability.

Our industry is very competitive, which may unfavorably impact our results of operations.

The property/casualty insurance market, our primary source of revenue, is highly competitive and, except for regulatory considerations, has very few barriers to entry. According to A.M. Best, there were 3,173 property/casualty insurance companies and 2,065 property/casualty insurance groups operating in North America as of July 24, 2006. Our HGA Operating Unit competes with a variety of large national standard commercial lines carriers such as The Hartford, Zurich North America, St. Paul Travelers and Safeco, as well as numerous smaller regional companies. The primary competition for our TGA Operating Unit's excess and surplus lines products includes such carriers as Atlantic Casualty Insurance Company, Colony Insurance Company, Burlington Insurance Company, Penn America Insurance Group and, to a lesser extent, a number of national standard lines carriers such as Zurich North America and The Hartford. Our Aerospace Operating Unit considers its primary competitors to be Houston Casualty Corp., Phoenix Aviation, W. Brown & Company, AIG and London Aviation Underwriters. Although our Phoenix Operating Unit competes with large national insurers such as Allstate, State Farm and Progressive, as a participant in the non-standard personal automobile marketplace its competition is most directly associated with numerous regional companies and managing general agencies. Our competitors include entities which have, or are affiliated with entities which have, greater financial and other resources than we have. In addition, competitors may attempt to increase market share by lowering rates. In that case, we could experience reductions in our underwriting margins, or sales of our insurance policies could decline as customers purchase lower-priced products from our competitors. Losing business to competitors offering similar products at lower prices, or having other competitive advantages, could adversely affect our results of operations.

Our results may be unfavorably impacted if we are unable to obtain adequate reinsurance.

As part of our overall risk and capacity management strategy, we purchase reinsurance for significant amounts of risk, especially catastrophe risks that we and our insurance company subsidiaries underwrite. Our catastrophe and non-catastrophe reinsurance facilities are generally subject to annual renewal. We may be unable to maintain our current reinsurance facilities or to obtain other reinsurance facilities in adequate amounts and at favorable rates. The amount, availability and cost of reinsurance are subject to prevailing market conditions beyond our control, and may affect our ability to write additional premiums as well as our profitability. If we are unable to obtain adequate reinsurance protection for the risks we have underwritten, we will either be exposed to greater losses from these risks or we will reduce the level of business that we underwrite, which will reduce our revenue.

If the companies that provide our reinsurance do not pay our claims in a timely manner, we could incur severe losses.

We purchase reinsurance by transferring, or ceding, part of the risk we have assumed to a reinsurance company in exchange for part of the premium we receive in connection with the risk. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred or ceded to the reinsurer, it does not relieve us of our liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers. We cannot assure that our reinsurers will pay all of our reinsurance claims, or that they will pay our claims on a timely basis. At December 31, 2006, we had a total of $7.6 million due us from reinsurers, including $6.0 million of recoverables from losses and $1.6 million in prepaid reinsurance premiums. The largest amount due us from a single reinsurer as of December 31, 2006 was $2.0 million reinsurance and premium recoverable from GE Reinsurance Corp. If any of our reinsurers are unable or unwilling to pay amounts they owe us in a timely fashion, we could suffer a significant loss or a shortage of liquidity, which would have a material adverse effect on our business and results of operations.

Catastrophic losses are unpredictable and may adversely affect our results of operations, liquidity and financial condition.

Property/casualty insurance companies are subject to claims arising out of catastrophes that may have a significant effect on their results of operations, liquidity and financial condition. Catastrophes can be caused by various events, including hurricanes, windstorms, earthquakes, hail storms, explosions, severe winter weather and fires, and may include man-made events, such as the September 11, 2001 terrorist attacks on the World Trade Center. The incidence, frequency, and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Claims from catastrophic events could reduce our net income, cause substantial volatility in our financial results for any fiscal quarter or year or otherwise adversely affect our financial condition, liquidity or results of operations. Catastrophes may also negatively affect our ability to write new business. Increases in the value and geographic concentration of insured property and the effects of inflation could increase the severity of claims from catastrophic events in the future.

Catastrophe models may not accurately predict future losses.

Along with other insurers in the industry, we use models developed by third-party vendors in assessing our exposure to catastrophe losses that assume various conditions and probability scenarios. However, these models do not necessarily accurately predict future losses or accurately measure losses currently incurred. Catastrophe models, which have been evolving since the early 1990s, use historical information about various catastrophes and detailed information about our in-force business. While we use this information in connection with our pricing and risk management activities, there are limitations with respect to their usefulness in predicting losses in any reporting period. Examples of these limitations are significant variations in estimates between models and modelers and material increases and decreases in model results due to changes and refinements of the underlying data elements and assumptions. Such limitations lead to questionable predictive capability and post-event measurements that have not been well understood or proven to be sufficiently reliable. In addition, the models are not necessarily reflective of company or state-specific policy language, demand surge for labor and materials or loss settlement expenses, all of which are subject to wide variation by catastrophe. Because the occurrence and severity of catastrophes are inherently unpredictable and may vary significantly from year to year, historical results of operations may not be indicative of future results of operations.

We are subject to comprehensive regulation, and our results may be unfavorably impacted by these regulations.

We are subject to comprehensive governmental regulation and supervision. Most insurance regulations are designed to protect the interests of policyholders rather than of the stockholders and other investors of the insurance companies. These regulations, generally administered by the department of insurance in each state in which we do business, relate to, among other things:

- approval of policy forms and rates;

- standards of solvency, including risk-based capital measurements, which are a measure developed by the National Association of Insurance Commissioners and used by the state insurance regulators to identify insurance companies that potentially are inadequately capitalized;
- licensing of insurers and their agents;
- restrictions on the nature, quality and concentration of investments;
- restrictions on the ability of insurance company subsidiaries to pay dividends;
- restrictions on transactions between insurance company subsidiaries and their affiliates;
- requiring certain methods of accounting;
- periodic examinations of operations and finances;
- the use of non-public consumer information and related privacy issues;
- the use of credit history in underwriting and rating;
- limitations on the ability to charge policy fees;
- the acquisition or disposition of an insurance company or of any company controlling an insurance company;
- involuntary assignments of high-risk policies, participation in reinsurance facilities and underwriting associations, assessments and other governmental charges;
- restrictions on the cancellation or non-renewal of policies and, in certain jurisdictions, withdrawal from writing certain lines of business;
- prescribing the form and content of records of financial condition to be filed;
- requiring reserves for unearned premium, losses and other purposes; and
- with respect to premium finance business, the federal Truth-in-Lending Act and similar state statutes. In states where specific statutes have not been enacted, premium finance is generally subject to state usury laws that are applicable to consumer loans.

State insurance departments also conduct periodic examinations of the affairs of insurance companies and require filing of annual and other reports relating to the financial condition of insurance companies, holding company issues and other matters. Our business depends on compliance with applicable laws and regulations and our ability to maintain valid licenses and approvals for our operations. Regulatory authorities may deny or revoke licenses for various reasons, including violations of regulations. Changes in the level of regulation of the insurance industry or changes in laws or regulations themselves or interpretations by regulatory authorities could have a material adverse affect on our operations. In addition, we could face individual, group and class-action lawsuits by our policyholders and others for alleged violations of certain state laws and regulations. Each of these regulatory risks could have an adverse effect on our profitability.

State statutes limit the aggregate amount of dividends that our subsidiaries may pay Hallmark, thereby limiting its funds to pay expenses and dividends.

Hallmark is a holding company and a legal entity separate and distinct from its subsidiaries. As a holding company without significant operations of its own, Hallmark's principal sources of funds are dividends and other sources of funds from its subsidiaries. State insurance laws limit the ability of Hallmark's insurance company subsidiaries to pay dividends and require our insurance company subsidiaries to maintain specified minimum levels of statutory capital and surplus. The aggregate maximum amount of dividends permitted by law to be paid by an insurance company does not necessarily define an insurance company's actual ability to pay dividends. The actual ability to pay dividends may be further constrained by business and regulatory considerations, such as the impact of dividends on surplus, by our competitive position and by the amount of premiums that we can write. Without regulatory approval, the aggregate maximum amount of dividends that could be paid to Hallmark in 2007 by our insurance company subsidiaries is $12.4 million. State insurance regulators have broad discretion to limit the payment of dividends by insurance companies and Hallmark's right to participate in any distribution of assets of one of our insurance company subsidiaries is subject to prior claims of policyholders and creditors except to the extent that its rights, if any, as a creditor are recognized. Consequently, Hallmark's ability to pay debts, expenses and cash dividends to our stockholders may be limited.

Our insurance company subsidiaries are subject to minimum capital and surplus requirements. Failure to meet these requirements could subject us to regulatory action.

Our insurance company subsidiaries are subject to minimum capital and surplus requirements imposed under the laws of their respective states of domicile and each state in which they issue policies. Any failure by one of our insurance company subsidiaries to meet minimum capital and surplus requirements imposed by applicable state law will subject it to corrective action, which may include requiring adoption of a comprehensive financial plan, revocation of its license to sell insurance products or placing the subsidiary under state regulatory control. Any new minimum capital and surplus requirements adopted in the future may require us to increase the capital and surplus of our insurance company subsidiaries, which we may not be able to do.

We are subject to assessments and other surcharges from state guaranty funds, mandatory reinsurance arrangements and state insurance facilities, which may reduce our profitability.

Virtually all states require insurers licensed to do business therein to bear a portion of the unfunded obligations of impaired or insolvent insurance companies. These obligations are funded by assessments, which are levied by guaranty associations within the state, up to prescribed limits, on all member insurers in the state on the basis of the proportionate share of the premiums written by member insurers in the lines of business in which the impaired, insolvent or failed insurer was engaged. Accordingly, the assessments levied on us by the states in which we are licensed to write insurance may increase as we increase our premiums written. In addition, as a condition to the ability to conduct business in certain states, insurance companies are required to participate in mandatory reinsurance funds such as the Texas Property and Casualty Insurance Guaranty Association. The effect of these assessments and mandatory reinsurance arrangements, or changes in them, could reduce our profitability in any given period or limit our ability to grow our business.

We are currently monitoring developments with respect to various state facilities, such as the Texas FAIR Plan and the Texas Windstorm Insurance Association, and the various guaranty funds in which we participate. The ultimate impact of recent catastrophe experience on these facilities is currently uncertain but could result in the facilities recognizing a financial deficit or a financial deficit greater than the level currently estimated. They may, in turn, have the ability to assess participating insurers when financial deficits occur, adversely affecting our results of operations. While these facilities are generally designed so that the ultimate cost is borne by policyholders, the exposure to assessments and the availability of recoupments or premium rate increases from these facilities may not offset each other in our financial statements. Moreover, even if they do offset each other, they may not offset each other in financial statements for the same fiscal period due to the ultimate timing of the assessments and recoupments or premium rate increases, as well as the possibility of policies not being renewed in subsequent years.

Adverse securities market conditions can have a significant and negative impact on our investment portfolio.

Our results of operations depend in part on the performance of our invested assets. As of December 31, 2006, 97.2% of our investment portfolio was invested in fixed-income securities. Certain risks are inherent in connection with fixed-income securities, including loss upon default and price volatility in reaction to changes in interest rates and general market factors. In general, the fair market value of a portfolio of fixed-income securities increases or decreases inversely with changes in the market interest rates, while net investment income realized from future investments in fixed-income securities increases or decreases along with interest rates. In addition, 8.8% of our fixed-income securities have call or prepayment options. This subjects us to reinvestment risk should interest rates fall and issuers call their securities. Furthermore, actual net investment income and/or cash flows from investments that carry prepayment risk, such as mortgage-backed and other asset-backed securities, may differ from those anticipated at the time of investment as a result of interest rate fluctuations. An investment has prepayment risk when there is a risk that cash flows from the repayment of principal might occur earlier than anticipated because of declining interest rates or later than anticipated because of rising interest rates. The fair value of our fixed-income securities as of December 31, 2006 was $158.3 million. If market interest rates were to change 1%, for example, from 5% to 6%, the fair value of our fixed-income securities would change approximately $3.9 million as of December 31, 2006. The calculated change in fair value was determined using duration modeling assuming no prepayments.

In addition to the general risks described above, although 89.9% of our portfolio is investment-grade, our fixed-income securities are nonetheless subject to credit risk. If any of the issuers of our fixed-income securities suffer financial setbacks, the ratings on the fixed-income securities could fall (with a concurrent fall in market value) and, in a worst case scenario, the issuer could default on its obligations. Future changes in the fair market value of our available-for-sale securities will be reflected in other comprehensive income. Similar treatment is not available for liabilities. Therefore, interest rate fluctuations could adversely affect our stockholders' equity, total comprehensive income and/or our cash flows.

We rely on independent agents and specialty brokers to market our products and their failure to do so would have a material adverse effect on our results of operations.

We market and distribute our insurance programs exclusively through independent insurance agents and specialty insurance brokers. As a result, our business depends in large part on the marketing efforts of these agents and brokers and on our ability to offer insurance products and services that meet the requirements of the agents, the brokers and their customers. However, these agents and brokers are not obligated to sell or promote our products and many sell or promote competitors' insurance products in addition to our products. Some of our competitors have higher financial strength ratings, offer a larger variety of products, set lower prices for insurance coverage and/or offer higher commissions than we do. Therefore, we may not be able to continue to attract and retain independent agents and brokers to sell our insurance products. The failure or inability of independent agents and brokers to market our insurance products successfully could have a material adverse impact on our business, financial condition and results of operations.

We may experience difficulty in integrating recent or future acquisitions into our operations.

We completed the acquisitions of the subsidiaries now comprising our TGA Operating Unit and our Aerospace Operating Unit during January 2006. We may pursue additional acquisitions in the future. The successful integration of newly acquired businesses into our operations will require, among other things, the retention and assimilation of their key management, sales and other personnel; the coordination of their lines of insurance products and services; the adaptation of their technology, information systems and other processes; and the retention and transition of their customers. Unexpected difficulties in integrating any acquisition could result in increased expenses and the diversion of management time and resources. If we do not successfully integrate any acquired business into our operations, we may not realize the anticipated benefits of the acquisition, which could have a material adverse impact on our financial condition and results of operations. Further, any potential acquisitions may require significant capital outlays and, if we issue equity or convertible debt securities to pay for an acquisition, the issuance may be dilutive to our existing stockholders.

Our geographic concentration ties our performance to the business, economic and regulatory conditions of certain states.

The following states account for 88.5% of our gross written premiums for 2006: Texas (49.0%), Oregon (15.6%), New Mexico (10.8%), Idaho (7.5%) and Arizona (5.6%). Our revenues and profitability are subject to the prevailing regulatory, legal, economic, political, demographic, competitive, weather and other conditions in the principal states in which we do business. Changes in any of these conditions could make it less attractive for us to do business in such states and would have a more pronounced effect on us compared to companies that are more geographically diversified. In addition, our exposure to severe losses from localized natural perils, such as windstorms or hailstorms, is increased in those areas where we have written significant numbers of property/casualty insurance policies.

The exclusions and limitations in our policies may not be enforceable.

Many of the policies we issue include exclusions or other conditions that define and limit coverage, which exclusions and conditions are designed to manage our exposure to certain types of risks and expanding theories of legal liability. In addition, many of our policies limit the period during which a policyholder may bring a claim under the policy, which period in many cases is shorter than the statutory period under which these claims can be brought by our policyholders. While these exclusions and limitations help us assess and control our loss exposure, it is possible that a court or regulatory authority could nullify or void an exclusion or limitation, or legislation could be enacted modifying or barring the use of these exclusions and limitations. This could result in higher than anticipated losses and loss adjustment expenses by extending coverage beyond our underwriting intent or increasing the number or size of claims, which could have a material adverse effect on our operating results. In some instances, these changes may not become apparent until some time after we have issued the insurance policies that are affected by the changes. As a result, the full extent of liability under our insurance contracts may not be known for many years after a policy is issued.

We rely on our information technology and telecommunications systems and the failure or disruption of these systems could disrupt our operations and adversely affect our results of operations.

Our business is highly dependent upon the successful and uninterrupted functioning of our information technology and telecommunications systems. We rely on these systems to process new and renewal business, provide customer service, make claims payments and facilitate collections and cancellations, as well as to perform actuarial and other analytical functions necessary for pricing and product development. Our systems could fail of their own accord or might be disrupted by factors such as natural disasters, power disruptions or surges, computer hackers or terrorist attacks. Failure or disruption of these systems for any reason could interrupt our business and adversely affect our results of operations.

Item 1B. Unresolved Staff Comments.

Not applicable

Item 2. Properties.

Our corporate headquarters and HGA Operating Unit are located at 777 Main Street, Suite 1000, Fort Worth, Texas. The suite is located in a high-rise office building and contains approximately 27,808 square feet of space. The rent is currently $32,327 per month pursuant to a lease which expires June 30, 2011. Our corporate headquarters also occupies eight offices in an executive suite located in the same building for $7,625 per month under a lease which expires September 30, 2007.

Our TGA Operating Unit is located at 7411 John Smith, San Antonio, Texas. The suite is located in a high-rise office building and contains approximately 18,904 square feet of space. The rent is currently $27,528 per month pursuant to a lease which expires June 30, 2010. Our TGA Operating Unit also maintains a small branch office in Lubbock, Texas. Rent on this branch office is currently $1,025 per month under a lease which expires April 30, 2009.

Our Aerospace Operating Unit is located at 14990 Landmark Boulevard, Suite 300, Addison, Texas. The suite is located in a low-rise office building and contains approximately 8,925 square feet of space. The rent is currently $13,387 per month pursuant to a lease which expires September 30, 2010. Our Aerospace Operating Unit also maintains a branch office in Glendale, California. Rent on the 1,196 square foot suite is currently $2,332 per month pursuant to a lease which expires August 1, 2009.

Our Phoenix Operating Unit is located at 14651 Dallas Parkway, Suite 400, Dallas, Texas. The suite is located in a high-rise office building and contains approximately 25,559 square feet of space. The rent is currently $50,075 per month pursuant to a lease which expires November 30, 2008.

Item 3. Legal Proceedings.

We are engaged in various legal proceedings which are routine in nature and incidental to our business. None of these proceedings, either individually or in the aggregate, are believed, in our opinion, to have a material adverse effect on our consolidated financial position or our results of operations.

Item 4. Submission of Matters to a Vote of Security Holders.

During the fourth quarter of 2006, we did not submit any matter to a vote of our security holders.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Market for Common Stock

Our common stock is currently traded on the Nasdaq Global Market under the symbol "HALL." Prior to October 6, 2006, our common stock traded on the American Stock Exchange under the symbol "HAF" and prior to August 10, 2005, traded on the American Stock Exchange's Emerging Company Marketplace under the symbol "HAF.EC." The following table shows the high and low sales prices of our common stock on the Nasdaq Global Market, the American Stock Exchange or the American Stock Exchange's Emerging Company Marketplace for each quarter since January 1, 2005.

Period	High Sale	Low Sale
Year Ended December 31, 2005:		
First quarter.	$ 9.60	$ 6.66
Second quarter	9.00	5.70
Third quarter	8.34	6.54
Fourth quarter	8.22	6.30

Year Ended December 31, 2006:		
First quarter.	$ 12.30	$ 8.16
Second quarter	12.00	8.52
Third quarter	14.40	10.15
Fourth quarter	11.40	8.50

Holders

As of March 7, 2007 there were approximately 1,123 shareholders of record of our common stock.

Dividends

Hallmark has never paid dividends on its common stock. Our board of directors intends to continue this policy for the foreseeable future in order to retain earnings for development of our business.

Hallmark is a holding company and a legal entity separate and distinct from its subsidiaries. As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to pay dividends and make other payments. State insurance laws limit the ability of our insurance company subsidiaries to pay dividends to Hallmark. As a property/casualty insurance company domiciled in the State of Texas, AHIC is limited in the payment of dividends to Hallmark in any 12-month period, without the prior written consent of the Texas Department of Insurance, to the greater of statutory net income for the prior calendar year or 10% of statutory policyholders surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds. PIIC, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year policyholders surplus or prior year's net investment income, without prior written approval from the Arizona Department of Insurance. GSIC, domiciled in Oklahoma, is limited in the payment of dividends to the greater of 10% of prior year policyholders surplus or prior year's statutory net income, without prior written approval from the Oklahoma Insurance Department.

Equity Compensation Plan Information

The following table sets forth information regarding shares of our common stock authorized for issuance under our equity compensation plans as of December 31, 2006.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)]
	(a)	(b)	(c)
Equity compensation plans approved by security holders[1]	315,668	$7.30	635,834
Equity compensation plans not approved by security	16,666	$2.25	- 0 -

holders[2]			
Total	332,334	$7.04	635,834

1

Includes shares of our common stock authorized for issuance under our 2005 Long Term Incentive Plan, as well as shares of our common stock issuable upon exercise of options outstanding under our 1994 Key Employee Long Term Incentive Plan and our 1994 Non-Employee Director Stock Option Plan, both of which terminated in accordance with their terms in 2004.

2

Represents shares of our common stock issuable upon exercise of non-qualified stock options granted to our non-employee directors in lieu of cash compensation for their service on the board of directors during fiscal 1999. The options became fully exercisable on August 16, 2000, and terminate on March 15, 2010, to the extent not previously exercised.

Issuer Repurchases

We did not repurchase any shares of our common stock during the fourth quarter of 2006.

Performance Graph

The line graph below compares the cumulative total stockholder return on our common stock from January 1, 2002, through December 31, 2006, with the return on the Nasdaq Composite Index, Nasdaq Insurance Index, Amex Composite Index and S&P Property & Casualty Insurance Index for the same period. In accordance with Securities and Exchange Commission rules, the measurement assumes a $100 initial investment in our common stock with all dividends reinvested, and a $100 initial investment in the indices.

Item 6. Selected Financial Data

Year Ended December 31,

(1)

2006

2005

2004

2003

2002

(in thousands, except per share data)

Statement of Operations Data:

Gross premiums written	
	$ 213,945
	$89,467
	$33,389
	$43,338
	$51,643
Ceded premiums written	
	(11,017)
	(1,215)
	(322)
	(6,769)
	(29,611)
Net premiums written	
	202,928
	88,252
	33,067
	36,569
	22,032
Change in unearned premiums	
	(50,867)
	(29,068)
	(622)
	5,406

	(1,819)
Net premiums earned	
	152,061
	59,184
	32,445
	41,975
	20,213
Investment income, net of expenses	
	10,461
	3,836
	1,386
	1,198
	773
Realized gains (losses)	
	(1,466)
	58
	(27)
	(88)
	(5)
Finance charges	
	3,983
	2,044
	2,183

	3,544
	2,503
Commission and fees	
	35,343
	16,703
	21,100
	17,544
	1,108
Processing and service fees	
	2,330
	5,183
	6,003
	4,900
	921
Other income	
	29
	27
	31
	486
	284
Total revenues	
	202,741
	87,035

63,121

69,559

25,797

Losses and loss adjustment expenses

87,117

33,784

19,137

30,188

15,302

Other operating costs and expenses

83,583

38,492

35,290

37,386

9,474

Interest expense

5,798

1,264

64

1,271

983

Interest expense from amortization of discount on

convertible notes (2)

9,625

-

-

-

-

Amortization of intangible assets

2,293

27

28

28

2

Total expenses

188,416

73,567

54,519

68,873

25,761

Income before income tax, cumulative effect of

change in accounting principle and extraordinary gain

14,325

13,468

8,602

686

36

Income tax expense

5,134

4,282

2,753

25

13

Income before cumulative effect of change in

accounting principle and extraordinary gain

9,191

9,186

5,849

661

23

Cumulative effect of change in accounting principle,

net of tax (3)

-

-

-

-

(1,694)

Extraordinary gain (4)

-

-

-

8,084

-

Net income (loss)

$9,191

$9,186

$5,849

$8,745

($1,671)

Common stockholders basic earnings (loss) per share (5):					
Income (loss) before cumulative effect of change in accounting principle and extraordinary gain	$ 0.53	$ 0.76	$ 0.83	$ 0.14	$ 0.01
Cumulative effect of change in accounting principle (3)	-	-	-	-	(0.50)
Extraordinary gain (4)	-	-	-	1.66	-
Net income (loss)	$ 0.53	$ 0.76	$ 0.83	$ 1.80	$ (0.49)

Common stockholders diluted earnings (loss) per share (5):					
Income (loss) before cumulative effect of change in accounting principle and extraordinary gain	$ 0.53	$ 0.76	$ 0.82	$ 0.13	$ 0.01
Cumulative effect of change in accounting principle (3)	-	-	-	-	(0.50)
Extraordinary gain (4)	-	-	-	1.64	-

Net income (loss)	$ 0.53	$ 0.76	$ 0.82	$ 1.77	$ (0.49)

	As of December 31,				
Balance Sheet Items:	2006	2005	2004	2003	2002
Total investments	$ 155,639	$ 95,044	$ 32,121	$ 29,855	$ 16,728
Total assets	$ 415,953	$ 208,906	$ 82,511	$ 83,853	$ 83,761
Unpaid loss and loss adjustment expenses	$ 77,564	$ 26,321	$ 19,648	$ 28,456	$ 17,667
Unearned premiums	$ 91,606	$ 36,027	$ 6,192	$ 5,862	$ 15,957
Total liabilities	$ 265,222	$ 123,718	$ 49,855	$ 56,456	$ 75,226
Total stockholders' equity	$ 150,731	$ 85,188	$ 32,656	$ 27,397	$ 8,535
Book value per share (6)	$ 7.26	$ 5.89	$ 5.37	$ 4.52	$ 4.63

1 Includes the results of the Specialty Commercial Segment, all of which was acquired effective as of January 1, 2006.

2 In accordance with Financial Accounting Standards Board Emerging Issues Task Force Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," and Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," at the time of issuance we booked a $9.6 million deemed discount to convertible notes attributable to their conversion feature. Prior to conversion, this deemed discount was amortized as interest expense over the term of the notes, resulting in a $1.1 million non-cash interest expense during the first quarter of 2006. As a result of the subsequent conversion of the convertible notes, the $8.5 million balance of the deemed discount was written off as a non-cash interest expense during the quarter ending June 30, 2006. Neither the deemed discount on the convertible notes nor the resulting interest expense have any ultimate impact on cash flow or book value.

3 In 2002, we adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," which prohibits amortization of goodwill and requires annual testing of goodwill for impairment. In the year of adoption, we recognized a charge to earnings of $1.7 million to reflect an impairment loss that was reported as a cumulative effect of change in accounting principle.

4 In January 2003, we acquired PIIC in satisfaction of $7.0 million of a $14.85 million balance on a note receivable due from Millers American Group, Inc. This resulted in us recognizing an $8.1 million extraordinary gain in 2003.

5 In accordance with Statement of Financial Accounting Standards No. 128, "Earnings Per Share" ("SFAS 128"), we have restated the basic and diluted weighted average shares outstanding for the years 2004 and prior for the effect of a bonus element from our stockholder rights offerings that were successfully completed in 2005 and 2003. According to SFAS 128, there is an assumed bonus element in a rights issue whose exercise price is less than market value of the stock at the close of the rights offering period. This bonus element is treated as a stock dividend for reporting earnings per share. All per share amounts have also been adjusted to reflect a one-for-six reverse stock split effected July 31, 2006.

6 Book value per share is calculated as consolidated stockholders' equity on the basis of U.S. generally accepted accounting principles divided by the number of outstanding common shares. Book value per share has been adjusted to reflect a one-for-six reverse stock split effected July 31, 2006.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read together with our consolidated financial statements and the notes thereto. This discussion contains forward-looking statements. Please see

"Risks Associated with Forward-Looking Statements in this Form 10-K" and "Item 1A. Risk Factors" for a discussion of some of the uncertainties, risks and assumptions associated with these statements.

Overview

Hallmark is an insurance holding company which, through its subsidiaries, engages in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing commercial insurance in Texas, New Mexico, Idaho, Oregon, Montana, Louisiana, Oklahoma, Arkansas and Washington; marketing, distributing, underwriting and servicing non-standard personal automobile insurance in Texas, New Mexico, Arizona, Oklahoma, Arkansas, Idaho, Oregon and Washington; marketing, distributing, underwriting and servicing general aviation insurance in 47 states; and providing other insurance related services. We pursue our business activities through subsidiaries whose operations are organized into producing units and are supported by our insurance carrier subsidiaries.

Our non-carrier insurance activities are organized by producing units into the following reportable segments:

- Standard Commercial Segment.

The Standard Commercial Segment includes the standard lines commercial property/casualty insurance products and services handled by our HGA Operating Unit which is comprised of our Hallmark General Agency, Inc. and Effective Claims Management, Inc. subsidiaries.

- Specialty Commercial Segment.

The Specialty Commercial Segment primarily includes the excess and surplus lines commercial property/casualty insurance products and services handled by our TGA Operating Unit and the general aviation insurance products and services handled by our Aerospace Operating Unit. The Specialty Commercial Segment also includes a relatively small amount of non-strategic legacy personal lines insurance products handled by our TGA Operating Unit. Our TGA Operating Unit is comprised of our Texas General Agency, Inc., Pan American Acceptance Corporation and TGA Special Risk, Inc. subsidiaries. Our Aerospace Operating Unit is comprised of our Aerospace Insurance Managers, Inc., Aerospace Special Risk, Inc. and Aerospace Claims Management Group, Inc. subsidiaries. All of the subsidiaries included in the Specialty Commercial Segment were acquired effective January 1, 2006.

- Personal Segment.

The Personal Segment includes the non-standard personal automobile insurance products and services handled by our Phoenix Operating Unit which is comprised of American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc., both of which do business as Phoenix General Agency.

The retained premium produced by these reportable segments is supported by the following insurance company subsidiaries:

- American Hallmark Insurance Company of Texas

presently retains all of the risks on the commercial property/casualty policies marketed within the Standard Commercial Segment and assumes a portion of the risks on the commercial and aviation property/casualty policies marketed within the Specialty Commercial Segment.

- Gulf States Insurance Company

, which was acquired effective January 1, 2006, presently assumes a portion of the risks on the commercial property/casualty policies marketed within the Specialty Commercial Segment.

- Phoenix Indemnity Insurance Company

presently assumes all of the risks on the non-standard personal automobile policies marketed within the Personal Segment and assumes a portion of the risks on the aviation property/casualty products marketed within the Specialty Commercial Segment.

Effective January 1, 2006, our insurance company subsidiaries entered into a pooling arrangement which was subsequently amended on December 15, 2006 pursuant to which AHIC retains 46.0% of the total net premiums written, PIIC retains 34.1% of our total net premiums written and GSIC retains 19.9% of our total net premiums written.

Prior to January 1, 2006, the Standard Commercial Segment was referred to as our Commercial Insurance Operation and the Personal Segment was referred to as our Personal Insurance Operation. The retained premium produced by our operating units prior to January 1, 2006 was supported by our AHIC and PIIC insurance subsidiaries. Discussions for periods prior to January 1, 2006 do not include the operations of the Specialty Commercial Segment, all of which was acquired on January 1, 2006.

Each of our four operating units was reported as a separate segment during the first three quarters of 2006. Commencing in the fourth quarter of 2006, our HGA Operating Unit was designated as the sole component of the Standard Commercial Segment, our TGA Operating Unit and our Aerospace Operating Unit were aggregated in the Specialty Commercial Segment and our Phoenix Operating Unit was designated as the sole component of the Personal Segment.

Critical Accounting Estimates and Judgments

The significant accounting policies requiring our estimates and judgments are discussed below. Such estimates and judgments are based on historical experience, changes in laws and regulations, observance of industry trends and information received from third parties. While the estimates and judgments associated with the application of these accounting policies may be affected by different assumptions or conditions, we believe the estimates and judgments associated with the reported consolidated financial statement amounts are appropriate in the circumstances. For additional discussion of our accounting policies, see Note 1 to the audited consolidated financial statements included in this report.

Valuation of investments.

We complete a detailed analysis each quarter to assess whether any decline in the fair value of any investment below cost is deemed other-than-temporary. All securities with an unrealized loss are reviewed. Unless other factors cause us to reach a contrary conclusion, investments with a fair market value significantly less than cost for more than 180 days are deemed to have a decline in value that is other-than-temporary. A decline in value that is considered to be other-than-temporary is charged to earnings based on the fair value of the security at the time of assessment, resulting in a new cost basis for the security.

Risks and uncertainties are inherent in our other-than-temporary decline in value assessment methodology. Risks and uncertainties include, but are not limited to, incorrect or overly optimistic assumptions about financial condition or liquidity, incorrect or overly optimistic assumptions about future prospects, unfavorable changes in economic or social conditions and unfavorable changes in interest rates or credit ratings.

Deferred policy acquisition costs.

Policy acquisition costs (mainly commission, underwriting and marketing expenses) that vary with and are primarily related to the production of new and renewal business are deferred and charged to operations over periods in which the related premiums are earned. Ceding commissions from reinsurers, which include expense allowances, are deferred and recognized over the period premiums are earned for the underlying policies reinsured.

The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. A premium deficiency exists if the sum of expected claim costs and claim adjustment expenses, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums and expected

investment income on those unearned premiums, as computed on a product line basis. We routinely evaluate the realizability of deferred policy acquisition costs. At December 31, 2006 and 2005, there was no premium deficiency related to deferred policy acquisition costs.

Goodwill.

Our consolidated balance sheet as of December 31, 2006 includes goodwill of acquired businesses of approximately $31.4 million. This amount has been recorded as a result of prior business acquisitions accounted for under the purchase method of accounting. Under Statement of Financial Accounting Standards No. 142, which we adopted as of January 1, 2002, goodwill is tested for impairment annually. We completed our last annual test for impairment during the fourth quarter of 2006 and determined that there was no indication of impairment.

A significant amount of judgment is required in performing goodwill impairment tests. Such tests include estimating the fair value of our reporting units. As required by Statement of Financial Accounting Standards No. 142, we compare the estimated fair value of each reporting unit with its carrying amount, including goodwill. Under Statement of Financial Accounting Standards No. 142, fair value refers to the amount for which the entire reporting unit may be bought or sold. Methods for estimating reporting unit values include market quotations, asset and liability fair values and other valuation techniques, such as discounted cash flows and multiples of earnings or revenues. With the exception of market quotations, all of these methods involve significant estimates and assumptions.

Deferred tax assets.

We file a consolidated federal income tax return. Deferred federal income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end. Deferred taxes are recognized using the liability method, whereby tax rates are applied to cumulative temporary differences based on when and how they are expected to affect the tax return. Deferred tax assets and liabilities are adjusted for tax rate changes. A valuation allowance is provided against our deferred tax assets to the extent that we do not believe it is more likely than not that future taxable income will be adequate to realize these future tax benefits.

Reserves for unpaid losses and loss adjustment expenses.

Reserves for unpaid losses and loss adjustment expenses are established for claims which have already been incurred by the policyholder but which we have not yet paid. Unpaid losses and loss adjustment expenses represent the estimated ultimate net cost of all reported and unreported losses incurred through each balance sheet date. The reserves for unpaid losses and loss adjustment expenses are estimated using individual case-basis valuations and statistical analyses. These reserves are revised periodically and are subject to the effects of trends in loss severity and frequency. (See, "Item 1. Business - Analysis of Losses and LAE" and "-Analysis of Loss and LAE Reserve Development.")

Although considerable variability is inherent in such estimates, we believe that our reserves for unpaid losses and loss adjustment expenses are adequate. Due to the inherent uncertainty in estimating unpaid losses and loss adjustment expenses, the actual ultimate amounts may differ from the recorded amounts. A small percentage change could result in a material effect on reported earnings. For example, a 1% change in December 31, 2006 reserves for unpaid losses and loss adjustment expenses would have produced a $0.8 million change to pretax earnings. The estimates are continually reviewed and adjusted as experience develops or new information becomes known. Such adjustments are included in current operations.

An actuarial range of ultimate unpaid losses and loss adjustment expenses is developed independent of management's best estimate and is only used to check the reasonableness of that estimate. There is no exclusive method for determining this range, and judgment enters into the process. The primary actuarial technique utilized is a loss development analysis in which ultimate losses are projected based upon historical development patterns. The primary assumption underlying this loss development analysis is that the historical development patterns will be a reasonable predictor of the future development of losses for accident years which are less mature. An alternate actuarial technique, known as the Bornhuetter-Ferguson method, combines an analysis of loss development patterns with an initial estimate of expected losses or loss ratios. This approach is most useful for recent accident years. In addition to assuming the stability of loss development patterns, this technique is heavily dependent on the accuracy of the initial estimate of expected losses or loss ratios. Consequently, the Bornhuetter-Ferguson method is primarily used to

confirm the results derived from the loss development analysis.

The range of unpaid losses and loss adjustment expenses estimated by our actuary as of December 31, 2006 was $62.5 million to $88.8 million. Our best estimate of unpaid losses and loss adjustment expenses as of December 31, 2006 is $77.6 million. Our carried reserve for unpaid losses and loss adjustment expenses as of December 31, 2006 is comprised of $38.9 million in case reserves and $38.7 million in incurred but not reported reserves. In setting this estimate of unpaid losses and loss adjustment expenses, we have assumed, among other things, that current trends in loss frequency and severity will continue and that the actuarial analysis was empirically valid. In the absence of any specific factors indicating actual experience at either extreme of the actuarial range, we have established a best estimate of unpaid losses and loss adjustment expenses which is approximately $1.9 million higher than the midpoint of the actuarial range. It would be expected that management's best estimate would move within the actuarial range from year to year due to changes in our operations and changes within the marketplace. Due to the inherent uncertainty in reserve estimates, there can be no assurance that the actual losses ultimately experienced will fall within the actuarial range. However, because of the breadth of the actuarial range, we believe that it is reasonably likely that actual losses will fall within such range.

Our reserve requirements are also interrelated with product pricing and profitability. We must price our products at a level sufficient to fund our policyholder benefits and still remain profitable. Because claim expenses represent the single largest category of our expenses, inaccuracies in the assumptions used to estimate the amount of such benefits can result in our failing to price our products appropriately and to generate sufficient premiums to fund our operations.

Recognition of profit sharing commissions.

Profit sharing commission is calculated and recognized when the loss ratio, as determined by a qualified actuary, deviates from contractual targets. We receive a provisional commission as policies are produced as an advance against the later determination of the profit sharing commission actually earned. The profit sharing commission is an estimate that varies with the estimated loss ratio and is sensitive to changes in that estimate.

The following table details the profit sharing commission revenue sensitivity of the Standard Commercial Segment to the actual ultimate loss ratio for each effective quota share treaty at 5.0% above and below the current estimate, which we believe is a reasonably likely range of variance.

	Treaty Effective Dates			
	7/1/01	7/1/02	7/1/03	7/1/04
Provisional loss ratio	60.0%	59.0%	59.0%	64.2%
Estimated ultimate loss ratio profit sharing commission booked at December 31, 2006	61.5%	60.5%	60.0%	61.5%
Effect of actual 5.0% above estimated loss ratio at December 31, 2006	($807,577)	($2,451,606)	($3,130,187)	($1,958,759)
Effect of actual 5.0% below estimated loss ratio at December 31, 2006	$1,594,965	$2,132,946	$2,072,880	$1,958,759

The following table details the profit sharing commission revenue sensitivity of the Specialty Commercial Segment for the effective quota share treaty with Republic at 5.0% above and below the current estimate, which we believe is a reasonably likely range of variance.

	Treaty Effective Date
	1/1/06

Provisional loss ratio	65.0%
Estimated ultimate loss ratio booked to at December 31, 2006	65.0%
Effect of actual 5.0% above estimated loss ratio at December 31, 2006	-
Effect of actual 5.0% below estimated loss ratio at December 31, 2006	$1,650,155

Results of Operations

Comparison of Years ended December 31, 2006 and December 31, 2005

Management overview.

During fiscal 2006, our total revenues were $202.7 million, representing a 132.9% increase over the $87.0 million in total revenues for fiscal 2005. The acquisition of the subsidiaries included in the Specialty Commercial Segment in the first quarter of 2006 contributed $80.7 million to the increase in total revenues for the year ended December 31, 2006 as compared to the year ended December 31, 2005. The following table provides additional information concerning the increases in revenue contributed by these acquisitions.

		Year Ended December 31, 2006
		(in thousands)
Earned premium on retained business	$	39,670
Third party commission revenue		36,111
Investment income, finance charges and other revenue items		4,908
Revenue contributions from acquisitions	$	80,689

The retention of business produced in the Standard Commercial Segment that was previously retained by third parties also contributed $48.3 million to the increase in revenue, but was partially offset by lower ceding commission revenue of $15.7 million and lower processing and service fees of $2.7 million primarily attributable to the shift from a third-party agency structure to an insurance underwriting structure. Earned premium from the Personal Segment contributed $4.9 million and additional finance charges contributed $0.4 million to the increase in revenue, but were partially offset by lower ceding commission revenue of $1.8 million and lower processing and service fees of $0.3 million attributable to increased retention of the policies produced. The investment of funds derived from the implementation of our 2005 capital plan and a trust account to secure the future guaranteed payments to the sellers of acquired subsidiaries contributed another $3.4 million to revenue for fiscal 2006 as compared to fiscal 2005. These increases were partially offset by realized losses on our investment portfolio of $1.5 million in 2006.

We reported net income of $9.2 million for the year ended December 31, 2006, which is the same as the year ended December 31, 2005. On a diluted per share basis, net income was $0.53 for fiscal 2006 as compared to $0.76 for fiscal 2005. The

decrease in diluted earnings per share was partially due to issuing an additional 6.3 million shares during fiscal 2006. In addition, during fiscal 2006 we recorded $9.6 million of interest expense from amortization attributable to the deemed discount on convertible promissory notes issued in January, 2006 and converted to common stock during the second quarter of 2006. In the absence of this non-cash expense, our net income for the year ended December 31, 2006 would have been $15.3 million representing a 66.1% increase over the year ended December 31, 2005.

The following is a reconciliation of our net income without such interest expense to our reported results. Management believes this reconciliation provides useful supplemental information in evaluating the operating results of our business. This disclosure should not be viewed as a substitute for net income determined in accordance with GAAP.

	Year Ended December 31, 2006
	(in thousands)
Income excluding interest expense from amortization of discount, net of tax	$15,257
Interest expense from amortization of discount	9,625
Less related tax effect	(3,559)
	6,066
Net income	$9,191

Excluding the interest expense from amortization of discount, the increase in net income for the year ended December 31, 2006 versus the year ended December 31, 2005 was primarily attributable to the results of the newly acquired subsidiaries of the Specialty Commercial Segment, additional investment income and the retention of business produced by the Standard Commercial Segment beginning in the third quarter of 2005. These increases were partially offset by (i) additional interest expense on borrowings to finance the acquisitions of the subsidiaries in the Specialty Commercial Segment, (ii) lower results from the Personal Segment due primarily to favorable prior accident year loss development recognized in 2005 and the runoff of third party revenue recognized in 2005 from assuming 100% of the Texas non-standard auto business beginning in the fourth quarter of 2004, (iii) increased corporate operating expenses, (iv) realized losses on our investment portfolio and (v) additional income tax due to an increase in our federal statutory rate from 34% to 35% in 2006 attributable to higher taxable income.

The following is additional business segment information for the years ended December 31, 2006 and 2005:

	Year Ended December 31, 2006				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
			(in thousands)		
Produced premium	91,679	156,490	45,135	-	293,304
Gross premiums written	91,070	77,740	45,135	-	213,945
Ceded premiums written	(8,850)	(2,167)	-	-	(11,017)

Net premiums written	82,220	75,573	45,135	-	202,928
Change in unearned premiums	(12,146)	(35,903)	(2,818)		(50,867)
Net premiums earned	70,074	39,670	42,317	-	152,061
Total revenues	75,325	80,689	46,998	(271)	202,741
Losses and loss adjustment expenses	38,799	21,908	26,443	(33)	87,117
Pre-tax income (loss)	11,757	14,309	8,760	(20,501)	14,325
Net loss ratio (1)	55.4%	55.2%	62.5%		57.3%
Net expense ratio (2)	29.4%	30.5%	24.9%		28.4%
Net combined ratio (3)	84.8%	85.7%	87.4%		85.7%

	Year Ended December 31, 2005				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
			(in thousands)		
Produced premium	81,721	-	36,345	-	118,066
Gross premiums written	52,952	-	36,515	-	89,467
Ceded premiums written	(1,703)	-	488	-	(1,215)
Net premiums written	51,249	-	37,003	-	88,252
Change in unearned premiums	(29,498)	-	430	-	(29,068)
Net premiums earned	21,751	-	37,433	-	59,184
Total revenues	43,067	-	43,907	61	87,035
Losses and loss adjustment expenses	12,610	-	21,239	(65)	33,784
Pre-tax income (loss)	6,651	-	11,647	(4,830)	13,468
Net loss ratio (1)	58.0%		56.7%		57.1%
Net expense ratio (2)	34.4%		28.8%		30.8%
Net combined ratio (3)	92.4%		85.5%		87.9%

1

Net loss ratio is calculated as total net losses and loss adjustment expenses divided by net premiums earned, each determined in accordance with GAAP.

2

Net expense ratio is calculated as total underwriting expenses of our insurance company subsidiaries, including allocated overhead expenses and offset by agency fee income, divided by net premiums earned, each determined in accordance with GAAP. During the fourth quarter of fiscal 2006, we adopted the widely used industry calculation that offsets expenses with agency fee income. All prior period comparative expense ratios have been restated.

3

Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

Standard Commercial Segment.

Net written premium for the Standard Commercial Segment was $82.2 million for the year ended December 31, 2006, or 60.4% more than the $51.2 million for the year ended December 31, 2005. Beginning in the third quarter of fiscal 2005, the Standard Commercial Segment began retaining written premium through AHIC that was previously retained by third parties. On July 1, 2005, the Standard Commercial Segment assumed $20.1 million of in-force policies previously produced for Clarendon.

The total revenue for the Standard Commercial Segment of $75.3 million for the year ended December 31, 2006 was $32.3 million more than the $43.1 million reported the prior year. This 74.9% increase in total revenue was primarily due to an increase of $48.3 million in net premiums earned. Increased net investment income contributed an additional $2.2 million to the increase in total revenue. These increases were partially offset by lower ceding commission revenue of $15.6 million primarily due to the shift from a third party agency structure to an insurance underwriting structure and also affected by lower than expected profit sharing commission. The increase in total revenue was also partially offset by lower processing and service fees of $2.7 million attributable to the change to an insurance underwriting structure.

Pre-tax income for the Standard Commercial Segment of $11.8 million for the year ended December 31, 2006 increased $5.1 million, or 76.8%, over the $6.7 million reported for the prior year. Increased revenue, as discussed above, was the primary reason for the increase in pre-tax income, partially offset by increased losses and loss adjustment expenses of $26.2 million and additional operating expenses, mostly due to increased premium production, of $1.0 million. The Standard Commercial Segment reported a net loss ratio of 55.4% for the year ended December 31, 2006 as compared to a net loss ratio of 58.0% for the prior year. The loss ratios gross of reinsurance were 55.4% and 55.7% for the years ended December 31, 2006 and 2005, respectively. The slight decrease in the gross loss ratio was partially impacted by $0.2 million of favorable reserve development from prior accident years recognized during 2006. There was no prior year reserve development recognized during the year ended December 31, 2005 as we began retaining this business during the third quarter of 2005. The Standard Commercial Segment reported net expense ratios of 29.4% and 34.4% for the years ended December 31, 2006 and 2005, respectively. The net expense ratio for 2005 was higher primarily due to costs to assume from Clarendon the unearned premium previously produced by the Standard Commercial Segment.

Specialty Commercial Segment.

All of the subsidiaries included in the Specialty Commercial Segment were acquired effective January 1, 2006. The $80.7 million of total revenue was derived mostly from $39.7 million of earned premium on produced business that was assumed by our insurance company subsidiaries and third party commission revenue of $36.1 million on the

portion of business produced by the Specialty Commercial Segment that was retained by third parties. The remaining $4.9 million of revenue was primarily derived from investment income and finance charges.

Pre-tax income for the Specialty Commercial Segment of $14.3 million was primarily due to revenue as discussed above less (i) $42.0 million in operating expenses, comprised mostly of commission expense and salary related expenses, (ii) incurred losses and loss adjustment expenses of $21.9 million on the portion of business assumed by our insurance company subsidiaries, (iii) $2.3 million of amortization of intangible assets related to the acquisitions of the subsidiaries included in the Specialty Commercial Segment, and (iv) $0.2 million in interest expense.

Personal Segment.

Net premium written in the Personal Segment increased $8.1 million during the year ended December 31, 2006 to $45.1 million compared to $37.0 million for the year ended December 31, 2005. The increase in premium was due mostly to new state expansion during 2006.

Total revenue for the Personal Segment increased 7.0% to $47.0 million for the year ended December 31, 2006 from $43.9 million the prior year. Higher earned premium of $4.9 million and higher finance charges of $0.4 million was partially offset by lower ceding commission revenue of $1.8 million and lower processing and service fees of $0.3 million due to the 100% assumption of the Texas non-standard automobile premium beginning late in 2004.

Pre-tax income for the Personal Segment decreased $2.9 million, or 24.8%, for the year ended December 31, 2006 compared to the prior year. The primary reason for the decline in pre-tax income for the year ended December 31, 2006 was increased losses and loss adjustment expenses of $5.2 million as evidenced by an increase in the net loss ratio to 62.5% versus 56.7% reported in 2005. The increase in the net loss ratio was primarily attributable to a competitive pricing environment and favorable reserve development of $2.4 million recognized during 2005 as compared to $0.9 million recognized during 2006. In addition, new business written as a result of new programs and expansion into new states had not yet benefited from the reduced loss ratios typically associated with renewals of seasoned business. The increase in losses and loss adjustment expenses was partially offset by the increase in revenue discussed above. The Personal Segment reported net expense ratios of 24.9% and 28.8% for the years ended December 31, 2006 and 2005, respectively. The decrease in the net expense ratio was primarily a function of increased earned premium and policy fees income in 2006 without corresponding increases in expenses.

Corporate.

Total revenue for corporate decreased by $0.3 million for the year ended December 31, 2006 as compared to the prior year. The decrease was primarily due to $1.5 million in realized losses on our investment portfolio in 2006. This was partially offset by $1.0 million in interest earned on a trust account established in the first quarter of 2006 securing the guaranteed future payments to the sellers of acquired subsidiaries. (See Note 1, "Accounting Policies" and Note 8, "Structured Settlements.")

Corporate pre-tax loss was $20.5 million for the year ended December 31, 2006 as compared to $4.8 million for the prior year. The increased pre-tax loss was primarily due to $9.6 million in interest expense from amortization attributable to the deemed discount on convertible promissory notes issued in January, 2006. This interest expense had no impact on our cash flow or book value. Also contributing to the increased corporate pre-tax loss was additional interest expense of $4.3 million comprised of: (i) $1.1 million from the trust preferred securities issued in the second quarter of 2005 (see Note 7, "Notes Payable"); (ii) $1.1 million of amortization of the discount on the future guaranteed payments to the sellers of acquired subsidiaries (see Note 8, "Structured Settlements"); (iii) $1.0 million from a related party promissory note issued in January 2006; (iv) $0.8 million from borrowings under our revolving credit facility in January 2006 (see Note 7, "Notes Payable" and Note 9, "Credit Facilities"); and (v) $0.3 million from the convertible notes issued in January 2006. Also contributing to the increase in pre-tax loss was increased salary and related expenses of $0.9 million, professional services of $0.4 million, decreased revenue discussed above and travel

expenses of $0.2 million.

Comparison of Years ended December 31, 2005 and December 31, 2004

Management overview.

Total revenues for 2005 increased $23.9 million, or 37.9%, as compared to 2004, primarily as a result of a $19.5 million increase in revenues from the Standard Commercial Segment due to the transition to AHIC, beginning in the third quarter of 2005, of commercial premium previously produced for Clarendon. Income before tax for 2005 increased $4.9 million over 2004. The improvement in operating earnings reflected additional investment income on capital raised in 2005, the transition of the commercial business and improved underwriting results.

Segment information.

The following is additional business segment information for the year ended December 31, 2005 and 2004:

	Year Ended December 31, 2005				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
			(in thousands)		
Produced premium	81,721	-	36,345	-	118,066
Gross premiums written	52,952	-	36,515	-	89,467
Ceded premiums written	(1,703)	-	488	-	(1,215)
Net premiums written	51,249	-	37,003	-	88,252
Change in unearned premiums	(29,498)	-	430	-	(29,068)
Net premiums earned	21,751	-	37,433	-	59,184
Total revenues	43,067	-	43,907	61	87,035
Losses and loss adjustment expenses	12,610	-	21,239	(65)	33,784
Pre-tax income (loss)	6,651	-	11,647	(4,830)	13,468
Net loss ratio (1)	58.0%		56.7%		57.1%
Net expense ratio (2)	34.4%		28.8%		30.8%
Net combined ratio (3)	92.4%		85.5%		87.9%

	Year Ended December 31, 2004	
	Standard	Specialty

	Commercial Segment	Commercial Segment	Personal Segment	Corporate	Consolidated
			(in thousands)		
Produced premium	75,808	-	43,497	-	119,305
Gross premiums written	-	-	33,389	-	33,389
Ceded premiums written	-	-	(322)	-	(322)
Net premiums written	-	-	33,067	-	33,067
Change in unearned premiums	-	-	(622)	-	(622)
Net premiums earned	-	-	32,445	-	32,445
Total revenues	23,563	-	39,555	3	63,121
Losses and loss adjustment expenses	-	-	19,243	(106)	19,137
Pre-tax income (loss)	3,028	-	8,109	(2,535)	8,602
Net loss ratio (1)			59.3%		59.0%
Net expense ratio (2)			23.2%		23.2%
Net combined ratio (3)			82.5%		82.2%

1

Net loss ratio is calculated as total net losses and loss adjustment expenses divided by net premiums earned, each determined in accordance with GAAP.

2

Net expense ratio is calculated as total underwriting expenses of our insurance company subsidiaries, including allocated overhead expenses and offset by agency fee income, divided by net premiums earned, each determined in accordance with GAAP. During the fourth quarter of fiscal 2006, we adopted the widely used industry calculation that offsets expenses with agency fee income. All prior period comparative expense ratios have been restated.

3

Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

Standard Commercial Segment.

Beginning in the third quarter of 2005, the Standard Commercial Segment began retaining written premium through AHIC. Retention of this written premium was accomplished through the assumption of in-force policies from Clarendon at July 1, 2005, the assumption of Clarendon policies issued subsequent to July 1, 2005, and the issuance of AHIC policies. This resulted in net written premium of $51.2 million for 2005.

Total revenue for the Standard Commercial Segment of $43.1 million for 2005 was $19.5 million more than the $23.6 million reported in 2004. This 82.8% increase in total revenue was primarily due to net premiums earned of $21.8 million from the issuance of AHIC policies and the assumption of premium from Clarendon for business produced by this segment. Increased net investment income contributed $1.5 million to the increase in revenue. These increases in revenue were partially offset by lower ceding commission revenue of $3.2 million and lower processing and service fees of $0.6 million, in both cases due to the shift from a third-party agency structure to an insurance underwriting structure. Total earned premium generated by the Standard Commercial Segment for 2005, including premium retained by Clarendon, was $78.1 million as compared to $72.5 million for 2004.

Pretax income for the Standard Commercial Segment of $6.6 million for 2005 increased $3.6 million, or 119.6%, over the $3.0 million reported for 2004. Increased revenue, as discussed above, was the primary reason for the increase in pretax income, partially offset by losses and loss adjustment expenses of $12.6 million and additional production expenses of $3.2 million caused by increased retail agent commissions from higher premium production, as well as additional ceding commission expense from the assumption of premium from Clarendon. The Standard Commercial Segment had a loss ratio of 58.0% for 2005. The Standard Commercial Segment had no loss ratio for 2004 because we did not retain any of the premium produced by this segment during 2004.

Personal Segment.

Net premium written by the Personal Segment increased $3.9 million during 2005 to $37.0 million compared to $33.1 million during 2004. The increase was due mainly to AHIC assuming 100% of the Texas non-standard personal automobile business produced by this segment and underwritten by a third party, effective October 1, 2004. Prior to October 1, 2004, AHIC assumed only 45% of this business. Total premium production for 2005 declined $7.2 million, or 16.4%, to $36.3 million from the $43.5 million produced in 2004. The decline in produced premium reflected increased rate competition.

Revenue for the Personal Segment increased 11.0% to $43.9 million for 2005 from $39.6 million for 2004. Increased net premium earned of $5.0 million due to higher assumed premium volume was the primary cause of this increase. Also driving the increased revenue was a $0.9 million increase in investment income due to an increase in the investment portfolio from the completion of our capital plan. These increases were partially offset by a $1.2 million decrease in ceding commission income resulting from AHIC assuming 100% of the Texas non-standard personal automobile business effective October 1, 2004.

Pretax income for the Personal Segment increased $3.5 million, or 43.6%, for 2005 compared to 2004. Net investment income and realized gains and losses contributed $1.0 million to the increase in pretax income for 2005 over 2004. Improved underwriting results, as evidenced by a loss ratio of 56.7% in 2005 as compared to 59.3% in 2004, contributed $1.0 million to the increase in pretax income in 2005. Taking into consideration the effect on ceding commissions, losses and loss adjustment expenses and premium production costs, the changes in premium volume produced and assumed contributed approximately $0.9 million to the increase in pretax income. Lower technical service costs from integrating PIIC's back office systems that were previously outsourced contributed $0.4 million and lower salary and related expenses contributed $0.3 million to the increase in pretax income.

Corporate.

Corporate pretax loss was $4.8 million for 2005 as compared to $2.5 million for 2004. The increase was due mostly to additional interest expense of $1.2 million from the issuance of trust preferred securities in June 2005, increased salary expense of $0.6 million from increased headcount, including the transfer of accounting positions from both segments to Corporate late in 2004 and additional audit and legal fees of $0.2 million due primarily to the implementation of our capital plan in 2005.

Liquidity and Capital Resources

Sources and Uses of Funds

Our sources of funds are from insurance-related operations, financing activities and investing activities. Major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), commissions and processing and service fees. As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to meet operating expenses and debt obligations. As of December 31, 2006, Hallmark had $3.0 million in unrestricted cash and invested assets. Unrestricted cash and invested assets of our non-insurance subsidiaries were $5.3 million as of December 31, 2006.

Property/casualty insurance companies domiciled in the State of Texas are limited in the payment of dividends to their stockholders in any 12-month period, without the prior written consent of the Texas Department of Insurance, to the greater of statutory net income for the prior calendar year or 10% of statutory policyholders surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds. PIIC, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year policyholders surplus or prior year's net investment income, without prior written approval from the Arizona Department of Insurance. GSIC, domiciled in Oklahoma, is limited in the payment of dividends to the greater of 10% of prior year policyholders surplus or prior year's statutory net income, without prior written approval from the Oklahoma Insurance Department. During 2007, our insurance company subsidiaries' ordinary dividend capacity is $12.4 million. None of our insurance company subsidiaries paid a dividend to Hallmark during the year ended December 31, 2006 or 2005.

The state insurance departments also regulate financial transactions between our insurance subsidiaries and their affiliated companies. Applicable regulations require approval of management fees, expense sharing contracts and similar transactions. Phoenix General Agency paid $1.3 million, $1.8 million and $0.6 million in management fees to Hallmark during 2006, 2005 and 2004, respectively. PIIC paid $1.2 million in management fees to Phoenix General Agency during each of 2006, 2005 and 2004. AHIC did not pay any management fees during 2006, 2005 or 2004. GSIC did not pay any management fees during 2006.

Statutory capital and surplus is calculated as statutory assets less statutory liabilities. The various state insurance departments that regulate our insurance company subsidiaries require us to maintain a minimum statutory capital and surplus. As of December 31, 2006, our insurance company subsidiaries reported statutory capital and surplus of $133.9 million, substantially greater than the minimum requirements for each state. Each of our insurance company subsidiaries is also required to satisfy certain risk-based capital requirements. (See, "Item 1. Business - Insurance Regulation - Risk-based Capital Requirements.") As of December 31, 2006, the adjusted capital under the risk-based capital calculation of each of our insurance company subsidiaries substantially exceeded the minimum requirements.

For the year ended December 31, 2006, our total statutory premium-to-surplus percentage was 151% as compared to 88% for the year ended December 31, 2005. The additional retention of produced premium was the primary cause for this increase.

Comparison of December 31, 2006 to December 31, 2005

On a consolidated basis, our cash and investments, excluding restricted cash and investments, at December 31, 2006 were $237.1 million compared to $139.6 million at December 31, 2005. The acquisitions of the subsidiaries included in the Specialty Commercial Segment accounted for $21.0 million of this increase, while the remainder of the increase was primarily the result of the retention of business produced by both our Standard Commercial Segment and Specialty Commercial Segment.

Comparison of Years Ended December 31, 2006 and December 31, 2005

Net cash provided by our consolidated operating activities was $76.2 million for the year ended December 31, 2006 compared to $29.5 million for the year ended December 31, 2005. The increase in operating cash flow primarily resulted from the retention of business produced in the Standard Commercial Segment and Specialty Commercial Segment in 2006 that was not retained by us in 2005. The net effect on operating cash flows was an increase of $93.6

million resulting from an increase in collected premiums net of paid losses and loss adjustment expenses partially offset by lower collected commission and claim fee revenue. Increased collected commission revenue of $26.5 million primarily from the acquisition of the subsidiaries included in the Specialty Commercial Segment, increased collected investment income of $4.4 million and increased collected finance charges of $2.0 million primarily from the acquisition of PAAC were partially offset by an increase in paid operating expenses of $69.5 million driven primarily from these acquisitions, additional interest paid mostly on debt financing these acquisitions of $3.5 million and increased tax payments of $6.7 million due to higher taxable earnings.

Cash used by investing activities during the year ended December 31, 2006 was $91.8 million as compared to $73.1 million for the prior year. The increase in cash used by investing activities was mostly due to the acquisitions of the subsidiaries included in the Specialty Commercial Segment in the first quarter of 2006 which used $26.0 million, net of cash acquired. Also contributing to the increase in cash used by investing activities was the funding of $25.0 million to a trust account securing the future guaranteed payments to the sellers of acquired subsidiaries, as well as PAAC's $2.8 million repayment of premium finance notes, net of premium finance notes originated. Partially offsetting these uses was a $17.3 million increase in maturities and redemptions of investments (including short-term) in 2006 versus 2005, a decrease in purchases of debt and equity securities of $11.8 million and a release of $2.2 million from restricted cash and investments in 2006 versus $3.8 million transferred to restricted in 2005.

Cash provided by financing activities during the year ended December 31, 2006 was $52.6 million as compared to $75.1 million for the prior year.

The cash provided in 2006 was primarily from the issuance of three debt instruments in January. The first was a promissory note payable to Newcastle Partners, L.P. ("Newcastle Partners") in the amount of $12.5 million to fund the cash required to close the acquisition of the subsidiaries now comprising our Aerospace Operating Unit. This note bore interest at the rate of 10% per annum. The second debt instrument was $25.0 million in subordinated convertible promissory notes issued to Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P. (collectively, the "Opportunity Funds"). The principal and accrued interest on the convertible notes was converted to approximately 3.3 million shares of our common stock during the second quarter of 2006. The $25.0 million raised with these notes was used to fund a trust account securing future guaranteed payments to the sellers of the subsidiaries now comprising our TGA Operating Unit. The third debt instrument was $15.0 million borrowed under our revolving credit facility to fund the cash required to close the acquisition of the subsidiaries now comprising our TGA Operating Unit. In October 2006, we repaid the promissory note to Newcastle Partners and repaid $12.2 million of the outstanding principal balance of our revolving credit facility, in each case with $24.7 million in net proceeds received from our public equity offering. Newcastle Partners and the Opportunity Funds are each an affiliate of our Executive Chairman, Mark E. Schwarz.

Credit Facilities

On June 29, 2005, we entered into a credit facility with The Frost National Bank. The credit facility was amended and restated on January 27, 2006 to a $20.0 million revolving credit facility, with a $5.0 million letter of credit sub-facility. Principal outstanding under the revolving credit facility generally bears interest at the three month Eurodollar rate plus 2.00%, payable quarterly in arrears. During 2006, the interest rate ranged from 6.66% to 7.42% per annum. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guaranties of all of our subsidiaries and the pledge of substantially all of our assets. The revolving credit facility contains covenants which, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes, including prohibiting us from entering into new lines of business. The amended and restated credit agreement terminates on January 27, 2008. As of December 31, 2006, there was $2.8 million outstanding under our revolving credit facility, and we were in compliance with all of our covenants. In the third quarter of 2005, we issued a $4.0 million letter of credit under this facility to collateralize certain obligations under the agency agreement between Hallmark General Agency and Clarendon effective July 1, 2004.

PAAC has a $5.0 million revolving credit facility with JPMorgan Chase Bank which terminates June 30, 2007. Principal outstanding under this revolving credit facility generally bears interest at 1% above the prime rate. During 2006, the interest rate ranged from 7.25% to 8.25% per annum. PAAC's obligations under this revolving credit facility are secured by its premium finance notes receivables. This revolving credit facility contains various restrictive

covenants which, among other things, require PAAC to maintain minimum amounts of tangible net worth and working capital. As of December 31, 2006, $2.0 million was outstanding under this revolving credit facility and PAAC was in compliance with or had obtained waivers of all of its covenants.

Trust Preferred Securities

On June 21, 2005, our newly formed trust subsidiary completed a private placement of $30.0 million of 30-year floating-rate trust preferred securities. Simultaneously, we borrowed $30.9 million from the trust subsidiary and contributed $30.0 million to AHIC in order to increase policyholder surplus. The note bears an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three-month LIBOR rate plus 3.25%. As of December 31, 2006, the note balance was $30.9 million.

Other Debt Obligations

On January 3, 2006, we executed a promissory note payable to Newcastle Partners, L.P., an affiliate of our Executive Chairman, in the amount of $12.5 million in order to obtain funding to complete the acquisition of the subsidiaries now comprising our Aerospace Operating Unit. The promissory note bore interest at 10% per annum. The principal of the promissory note, together with accrued interest was repaid in October 2006 with the proceeds from our public equity offering.

On January 27, 2006, we issued an aggregate of $25.0 million in subordinated convertible promissory notes to Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P., affiliates of our Executive Chairman, in order to fund the structure settlement trust account related to our acquisition of the TGA Operating Unit. Each convertible note bore interest at 4% per annum, which rate would have increased to 10% per annum in the event of default. Interest was payable quarterly in arrears commencing March 31, 2006. Principal and all accrued but unpaid interest was due at maturity on July 27, 2007. The principal and accrued interest on the convertible notes was converted to approximately 3.3 million shares of our common stock during the second quarter of 2006.

Structured Settlements

In connection with our acquisition of the subsidiaries now comprising our TGA Operating Unit, we issued to the sellers promissory notes in the aggregate principal amount of $23.7 million payable $14.2 million on or before January 1, 2007, and $9.5 million on or before January 1, 2008. We are also obligated to pay to the sellers an additional $0.8 million on or before January 1, 2007 and an additional $0.5 million on or before January 1, 2008 in consideration of the sellers' compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. We secured payment of these future installments of purchase price and restrictive covenant consideration by depositing $25.0 million in a trust account for the benefit of the sellers. We recorded a payable for future guaranteed payments to the sellers of $25.0 million discounted at 4.4%, the rate of two year U.S. Treasuries purchased as the only permitted investment of the trust account. The trust account is classified in restricted cash and investments on our consolidated balance sheet. As of December 31, 2006, the balance of the structured settlements was $24.6 million.

Long-Term Contractual Obligations

Set forth below is a summary of long-term contractual obligations as of December 31, 2006. Amounts represent estimates of gross undiscounted amounts payable over time. In addition, certain unpaid losses and loss adjustment expenses are ceded to others under reinsurance contracts and are, therefore, recoverable. Such potential recoverables are not reflected in the table.

	Estimated Payments by Period

	Total	2007	2008-2009	2010-2011	After 2011
Notes payable	35,763	2,035	2,800	-	30,928
Interest on note payable	66,344	2,598	4,650	4,635	54,461
Structured settlements	25,000	15,000	10,000	-	-
Unpaid losses and loss adjustment expenses	77,564	39,238	29,629	6,355	2,342
Operating leases	5,251	1,705	2,565	981	-
Purchase obligations	5,158	991	1,744	1,605	818

Conclusion

Based on 2007 budgeted and year-to-date cash flow information, we believe that we have sufficient liquidity to meet our projected insurance obligations, operational expenses and capital expenditure requirements for the next 12 months.

Effects of Inflation

We do not believe that inflation has a material effect on our results of operations, except for the effect that inflation may have on interest rates and claim costs. The effects of inflation are considered in pricing and estimating reserves for unpaid losses and loss adjustment expenses. The actual effects of inflation on results of operations are not known until claims are ultimately settled. In addition to general price inflation, we are exposed to the upward trend in the judicial awards for damages. We attempt to mitigate the effects of inflation in the pricing of policies and establishing reserves for losses and loss adjustment expenses.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

We believe that interest rate risk, credit risk and equity risk are the types of market risk to which we are principally exposed.

Interest rate risk.

Our investment portfolio consists principally of investment-grade, fixed-income securities, all of which are classified as available-for-sale. Accordingly, the primary market risk exposure to these securities is interest rate risk. In general, the fair market value of a portfolio of fixed-income securities increases or decreases inversely with changes in market interest rates, while net investment income realized from future investments in fixed-income securities increases or decreases along with interest rates. The fair value of our fixed-income securities as of December 31, 2006 was $158.3 million. The effective duration of our portfolio as of December 31, 2006 was 2.5 years. Should interest rates increase 1.0%, our fixed-income investment portfolio would be expected to decline in market value by 2.5%, or $3.9 million, representing the effective duration multiplied by the change in market interest rates. Conversely, a 1.0% decline in interest rates would be expected to result in a 2.5%, or $3.9 million, increase in the market value of our fixed-income investment portfolio.

Credit risk.

An additional exposure to our fixed-income securities portfolio is credit risk. We attempt to manage the credit risk by investing primarily in investment-grade securities and limiting our exposure to a single issuer. As of December 31, 2006, our fixed-income investments were in the following: U.S. Treasury securities - 41.5%; municipal securities - 32.9%; and corporate securities - 25.6%. As of December 31, 2006, 89.9% of our fixed-income securities were rated investment-grade by nationally recognized statistical rating organizations.

We are also subject to credit risk with respect to reinsurers to whom we have ceded underwriting risk. Although a reinsurer is liable for losses to the extent of the coverage it assumes, we remain obligated to our policyholders in the event that the reinsurers do not meet their obligations under the reinsurance agreements. In order to mitigate credit risk to reinsurance companies, we use financially strong reinsurers with an A.M. Best rating of "A-" (Excellent) or better.

Equity price risk.

Investments in equity securities which are subject to equity price risk made up 2.8% of our portfolio as of December 31, 2006. The carrying values of equity securities are based on quoted market prices as of the balance sheet date. Market prices are subject to fluctuation and, consequently, the amount realized in the subsequent sale of an investment may significantly differ from the reported market value. Fluctuation in the market price of a security may result from perceived changes in the underlying economic characteristics of the issuer, the relative price of alternative investments and general market conditions. Furthermore, amounts realized in the sale of a particular security may be affected by the relative quantity of the security being sold.

The fair value of our equity securities as of December 31, 2006 was $4.6 million. The fair value of our equity securities would increase or decrease by $1.4 million assuming a hypothetical 30% increase or decrease in market prices as of the balance sheet date. This would increase or decrease stockholders' equity by 0.9%. The selected hypothetical change does not reflect what should be considered the best or worse case scenario.

Item 8. Financial Statements and Supplementary Data.

The following consolidated financial statements of the Company and its subsidiaries are filed as part of this report.

Description	Page Number
Report of Independent Registered Public Accounting Firm	F-2
Consolidated Balance Sheets at December 31, 2006 and 2005	F-3
Consolidated Statements of Operations for the Years Ended December 31, 2006, 2005 and 2004	F-4
Consolidated Statements of Stockholders' Equity and Comprehensive Income for the Years Ended December 31, 2006, 2005 and 2004	F-5
Consolidated Statements of Cash Flows for the Years Ended December 31, 2006, 2005 and 2004	F-7
Notes to Consolidated Financial Statements	F-8
Unaudited Selected Quarterly Information	F-34
Financial Statement Schedules	F-35

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

Our principal executive officer and principal financial officer have evaluated our disclosure controls and procedures and have concluded that such controls and procedures are effective as of the end of the period covered by this report. During the most recent fiscal quarter, there have been no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

The information required by Item 10 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

Item 11. Executive Compensation.

The information required by Item 11 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information required by Item 12 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

The information required by Item 13 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

Item 14. Principal Accounting Fees and Services.

The information required by Item 14 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

PART IV

Item 15. Exhibits, Financial Statement Schedules.

(a)(1) Financial Statements

The following consolidated financial statements, notes thereto and related information are included in Item 8 of this report:

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets at December 31, 2006 and 2005
Consolidated Statements of Operations for the Years Ended December 31, 2006, 2005 and 2004
Consolidated Statements of Shareholders' Equity and Comprehensive Income for the Years Ended December 31, 2006, 2005 and 2004
Consolidated Statements of Cash Flows for the Years Ended December 31, 2006, 2005 and 2004
Notes to Consolidated Financial Statements

(a)(2) Financial Statement Schedules

The following financial statement schedules are included in this report:

Unaudited Selected Quarterly Information	Page F-33
Schedule II - Condensed Financial Information of Registrant - Hallmark Financial Services, Inc. (Parent Company Only)	Page F-34
Schedule III - Supplemental Insurance Information	Page F-37
Schedule IV - Reinsurance	Page F-38
Schedule VI - Supplemental Information Concerning Property-Casualty Insurance Operations	Page F-39

(a)(3) Exhibit Index

The following exhibits are either filed with this report or incorporated by reference:

Exhibit Number	Description
3.1	Restated Articles of Incorporation of the registrant (incorporated by reference to Exhibit 3.1 to Amendment No. 1 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006).

3.2	Restated By-Laws of the registrant (incorporated by reference to Exhibit 3.2 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).
4.1	Specimen certificate for common stock, $0.18 par value, of the registrant (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006).
4.2	Indenture dated June 21, 2005, between Hallmark Financial Services, Inc. and JPMorgan Chase Bank, National Association (incorporated by reference to Exhibit 4.1 to the registrant's Current Report

	on Form 8-K filed June 27, 2005).
4.3	Amended and Restated Declaration of Trust of Hallmark Statutory Trust I dated as of June 21, 2005, among Hallmark Financial Services, Inc., as sponsor, Chase Bank USA, National Association, as Delaware trustee, and JPMorgan Chase Bank, National Association, as institutional trustee, and Mark Schwarz and Mark Morrison, as administrators (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed June 27, 2005).
4.4	Form of Junior Subordinated Debt Security Due 2035 (included in Exhibit 4.2 above).
4.5	Form of Capital Security Certificate

	(included in Exhibit 4.3 above).
4.6	First Restated Credit Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and The Frost National Bank (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed February 2, 2006).
4.7	Form of Registration Rights Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and Newcastle Special Opportunity Fund I, Ltd. and Newcastle Special Opportunity Fund II, L.P. (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed February 2, 2006).

10.1	Office Lease for 14651 Dallas Parkway, Dallas, Texas, dated January 1, 1995, between American Hallmark Insurance Company of Texas and Fults Management Company, as agent for The Prudential Insurance Company of America (incorporated by reference to Exhibit 10(a) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).
10.2	Tenth Amendment to Office Lease for 14651 Dallas Parkway, Dallas, Texas, dated May 5th, 2003, between American Hallmark Insurance Company of Texas and Fults Management Company, as agent for The Prudential Insurance Company of America (incorporated by

	reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended March 31, 2003).
10.3	Lease Agreement for 777 Main Street, Fort Worth, Texas, dated June 12, 2003 between Hallmark Financial Services, Inc. and Crescent Real Estate Funding I, L.P. (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2003).
10.4	Lease Agreement for 7411 John Smith Drive, San Antonio, Texas, dated February 18, 1997, between Pan American Acceptance Corporation and Medical Plaza Partners, Ltd. (incorporated by reference to Exhibit 10.4 to the registrant's Registration

	Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).
10.5	Amendment No. 1 to Lease Agreement for 7411 John Smith Drive, San Antonio, Texas, dated June 10, 2002, between Pan American Acceptance Corporation and San Antonio Technology Center Corporation, as successor to Medical Plaza Partners, Ltd. (incorporated by reference to Exhibit 10.5 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).
10.6	Amendment No. 2 to Lease Agreement for 7411 John Smith Drive, San Antonio, Texas, dated February 27, 2003, between Pan American Acceptance

	Corporation and San Antonio Technology Center Corporation, as successor to Medical Plaza Partners, Ltd. (incorporated by reference to Exhibit 10.6 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).
10.7	Amendment No. 3 to Lease Agreement for 7411 John Smith Drive, San Antonio, Texas, dated November 10, 2004, between Pan American Acceptance Corporation and San Antonio Technology Center Corporation, as successor to Medical Plaza Partners, Ltd. (incorporated by reference to Exhibit 10.7 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8,

2006).

10.8	Amended and Restated Lease Agreement for 14990 Landmark Boulevard, Addison, Texas, dated December 13, 2005, between Aerospace Managers, Inc. and Donnell Investments, L.L.C. (incorporated by reference to Exhibit 10.8 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).
10.9*	1994 Key Employee Long Term Incentive Plan (incorporated by reference to Exhibit 10(f) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).
10.10*	First Amendment to Hallmark Financial Services, Inc.

	1994 Key Employee Long Term Incentive Plan (incorporated by reference to Exhibit 10(bm) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002).
10.11*	1994 Non-Employee Director Stock Option Plan (incorporated by reference to Exhibit 10(g) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).
10.12*	First Amendment to Hallmark Financial Services, Inc. 1994 Non-Employee Director Stock Option Plan (incorporated by reference to Exhibit 10(bn) to the registrant's Annual Report on Form 10-KSB for the fiscal year

ended December 31, 2002).

10.13*	Second Amendment to Hallmark Financial Services, Inc. 1994 Non-Employee Director Stock Option Plan (incorporated by reference to Exhibit 10(e) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2001).
10.14*	Form of Indemnification Agreement between Hallmark Financial Services, Inc. and its officers and directors, adopted July 19, 2002 (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2002).
10.15*	Hallmark Financial Services, Inc. 2005 Long Term Incentive

	Plan (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed June 3, 2005).
10.16*	Form of Incentive Stock Option Grant Agreement (incorporated by reference to Exhibit 10.2 to the registrant's Current Report on Form 8-K filed June 3, 2005).
10.17*	Form of Non-qualified Stock Option Agreement (incorporated by reference to Exhibit 10.3 to the registrant's Current Report on Form 8-K filed June 3, 2005).
10.18*	Employment Agreement dated as of February 1, 2006, among Aerospace Holdings, LLC, Hallmark Financial Services, Inc. and Curtis R. Donnell (incorporated by reference to Exhibit 10.18 to

the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).

10.19* Employment Agreement dated as of February 1, 2006, between Texas General Agency, Inc. and Donald E. Meyer (incorporated by reference to Exhibit 10.19 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).

10.20

Amortization of intangible assets	2,689	2,569	2,505	2,462	2,450	2,420	2,389	2,335
Operating profit	37,334	40,986	26,833	21,725	26,757	31,611	27,134	13,942
Net income attributable to Entegris, Inc.	29,175	32,522	21,988	40,161	17,859	21,673	18,037	11,256

	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
(Percent of net sales)								
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Gross profit	43.5	45.5	43.2	41.2	43.5	44.0	44.4	39.6
Selling, general and administrative expenses	17.6	18.7	19.4	19.8	20.0	19.1	21.2	22.2
Engineering, research and development	6.2	6.0	6.9	6.7	6.8	6.8	7.2	7.7

expenses								
Amortization of intangibles	1.3	1.2	1.4	1.5	1.5	1.3	1.3	1.4
Operating profit	18.4	19.6	15.5	13.3	15.3	16.8	14.7	8.3
Net income attributable to Entegris, Inc.	14.4	15.5	12.7	24.5	10.2	11.5	9.8	6.7

The Company s quarterly results of operations have been, and will likely continue to be, subject to significant fluctuations due to myriad factors, many of which are beyond the Company s control. The variability in sales, and its corresponding effect on gross profit, is the single most important factor underlying the changes in the Company s operating income over the past eight quarters. The fourth quarter of 2011 included a tax benefit of $21.0 million attributable to the release of the valuation allowance on certain deferred tax assets.

The Company s financial results for the two-year period ended December 31, 2012 reflected the improvement in both the capital and unit-driven segments of the semiconductor industry that began during the second half of 2009. Quarterly sales of the Company s products and services reached their peak in the second quarter of 2011, before declining over the latter half of 2011 due to a slowdown in semiconductor industry capital spending and sluggish production rates. 2012, which continued to be characterized by sluggish semiconductor production rates and industry capital spending, saw slowly increasing quarterly sales levels from late 2011 levels before declining in the fourth quarter of 2012.

Liquidity and Capital Resources

The Company has historically financed its operations and capital requirements through cash flow from its operating activities, long-term loans, lease financing and borrowings under domestic and international short-term lines of credit. In fiscal 2000 and 2009, the Company raised capital via public offerings of its common stock.

Operating activities

Net cash flow provided by operating activities totaled $115.2 million for the year ended December 31, 2012. Cash generated by the Company s operations included net income of $68.8 million, as adjusted for the impact of various non-cash charges, primarily depreciation and amortization of $37.6 million and share-based

compensation expense of $9.9 million. The net impact on cash flow from operations from changes in operating assets reduced cash otherwise generated by the Company s operations.

Working capital was $486.1 million at December 31, 2012, which included $350.4 million in cash and cash equivalents and short-term investments, an increase from $410.4 million as of December 31, 2011, which included $273.6 million in cash and cash equivalents.

Accounts receivable decreased by $13.2 million during 2012, or $10.6 million net of foreign currency translation adjustments. This decrease reflects the year-over-year decline sales of the Company s products and an improvement in the Company s collections as reflected in its days sales outstanding measure (DSO). The Company s DSO was 51 days at December 31, 2012 compared to 60 days at the beginning of the year.

Inventories at December 31, 2012 increased by $5.2 million from a year earlier, or $6.1 million after taking into account the impact of foreign currency translation adjustments and the provision for excess and obsolete inventory. The increase mainly reflects higher levels of finished goods.

Accounts payable and accrued expenses were $9.2 million higher than a year ago, or $6.3 million net of foreign currency translation adjustments. The Company made income tax payments, net of refunds, of $29.7 million in 2012.

Investing activities Cash flow used in investing activities totaled $72.5 million in 2012. Acquisition of property and equipment totaled $49.9 million, which primarily reflected significant investments in equipment and tooling to manufacture 450mm wafer handling products and to establish an advanced membrane manufacturing and development center for critical filtration applications.

As of December 31, 2012, the Company expects its capital expenditures in 2013 to be approximately $60 million to $70 million, including approximately $40 million to complete the Company s 450mm technology center and advanced membrane and coatings facility. Under the terms of its revolving credit facility, the Company is restricted from making capital expenditures in excess of $85 million during any fiscal year. The Company does not anticipate that this limit on capital expenditures will have an adverse effect on the Company s operations.

The Company had net purchases of $20.0 million less proceeds from maturities of commercial paper classified as short-term investments. Net of cash acquired, the Company expended $3.0 million to acquire the remaining 50% of an equity method investee in which it had previously owned a 50% equity interest.

Financing activities Cash provided by financing activities totaled $10.9 million during 2012. The Company received proceeds of $7.4 million in connection with common shares issued under the Company s stock plans. Cash provided by financing activities also included $3.9 million related to excess tax benefits from employee stock plans, partially offset by the purchase of shares of the Company s common stock at a total cost of $0.4 million under the stock repurchase program authorized by the Company s Board of Directors in 2011.

The Company has a revolving credit facility maturing June 9, 2014, with a revolving credit commitment of $30.0 million. As of December 31, 2012, the Company had no outstanding borrowings and $0.2 million undrawn on outstanding letters of credit under the revolving credit facility. Through December 31, 2012, the Company was in compliance with all applicable financial covenants included in the terms of the revolving credit facility.

The Company also has a line of credit with two banks that provide for borrowings of Japanese yen for the Company s Japanese subsidiary equivalent to an aggregate of approximately $14.0 million. There were no outstanding borrowings under these lines of credit at December 31, 2012.

On October 26, 2011, the Company announced that its Board of Directors had authorized the repurchase of up to an aggregate of $50.0 million of the Company s common stock in open market transactions and in accordance with a pre-arranged stock trading plan established on November 22, 2011 for the purpose of repurchasing up to $50 million of the registrant s common stock in accordance with Rule 10b5-1 under the Securities Exchange Act

of 1934, as amended (the Plan). The Plan commenced on November 28, 2011 and the expiration date of the Plan was extended until February 8, 2013. There have been no repurchases of the Company s common stock under the Plan during the quarter ended December 31, 2012.

On December 12, 2012, the Board of Directors authorized a repurchase program for 2013 covering up to an aggregate of $50.0 million of the Company s common stock in open market transactions and in accordance with one or more pre-arranged stock trading plans established in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. The repurchase program for 2013 will expire in December 2013 unless it is terminated or extended. The initial pre-arranged stock trading plan was established on February 19, 2013 and will expire August 19, 2013 and will cover the repurchase of up to $30 million of the registrant s common stock.

At December 31, 2012, the Company s shareholders equity stood at $694.8 million, up 14% from $608.2 million at the beginning of the year. The increase reflected net income attributable to the Company of $68.8 million, additional paid-in capital of $9.9 million associated with the Company s share-based compensation expense, $7.4 million received in connection with common shares issued under the Company s stock option and employee stock purchase plans, and a tax benefit associated with stock plans of $3.9 million, partially offset by the repurchase and retirement of its common stock of $0.4 million and foreign currency translation effects of $2.5 million.

As of December 31, 2012, the Company s sources of available funds were its cash and cash equivalents of $330.4 million, short-term investments of $20.0 million, funds available under its revolving credit facility and international credit facilities and cash flow generated from operations.

The Company believes that its cash and cash equivalents, short-term investments, funds available under its revolving credit facility and international credit facilities and cash flow generated from operations will be sufficient to meet its working capital and investment requirements for at least the next twelve months. If available liquidity is not sufficient to meet the Company s operating and debt service obligations as they come due, management would need to pursue alternative arrangements through additional equity or debt financing in order to meet the Company s cash requirements. There can be no assurance that any such financing would be available on commercially acceptable terms.

The Company considers the undistributed earnings of its foreign subsidiaries as of December 31, 2012 to be indefinitely reinvested. As of December 31, 2012, the amount of cash and cash equivalents associated with indefinitely reinvested foreign earnings was $113.0 million. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the United States. The Company does not anticipate the need to repatriate funds to the United States to satisfy domestic liquidity needs arising in the ordinary course of business and believes its existing balances of domestic cash and cash equivalents, and short-term investments and operating cash flows will be sufficient to meet the Company s domestic cash needs for the next twelve months.

New Accounting Pronouncements

The Company does not anticipate that recently issued accounting guidance that has not yet been adopted will have a material impact on its consolidated financial statements. Refer to Note 1 to the Company s consolidated financial statements for a discussion of accounting pronouncements implemented in 2012.

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Contractual Obligations

The following table summarizes the maturities of the Company s significant financial obligations as of December 31, 2012:

(In thousands)	Total	2013	2014	2015	2016	2017	Thereafter
Pension obligations	$ 12,225	$ 25	$ 285	$ 320	$ 219	$ 311	$ 11,065
Capital purchase obligations[1]	36,330	36,330					
Operating leases	25,813	8,288	4,361	4,073	3,221	2,566	3,304
Total	$ 74,368	$ 44,643	$ 4,646	$ 4,393	$ 3,440	$ 2,877	$ 14,369
Unrecognized tax benefits[2]							

1 Capital purchase obligations represent commitments for the construction or purchase of property, plant and equipment. They were not recorded as liabilities on the Company s consolidated balance sheet as of December 31, 2011, as the Company had not yet received the related goods or taken title to the property.

2 The Company had $5.4 million of total gross unrecognized tax benefits at December 31, 2012. The timing of any payments associated with these unrecognized tax benefits will depend on a number of factors. Accordingly, the Company cannot make reasonably reliable estimates of the amount and period of potential cash settlements, if any, with taxing authorities and are not included in the table above.

Non-GAAP Information The Company s consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States (GAAP).

The Company also provides certain non-GAAP financial measures as a complement to financial measures provided in accordance with GAAP in order to better assess and reflect trends affecting the Company s business and results of operations. Regulation G, *Conditions for Use of Non-GAAP Financial Measures*, and other regulations under the Securities Exchange Act of 1934, as amended, define and prescribe the conditions for use of certain non-GAAP financial information. The Company provides non-GAAP financial measures of Adjusted EBITDA and Adjusted Operating Income together with related measures thereof, and non-GAAP Earnings Per Share (EPS).

Adjusted EBITDA, a non-GAAP term, is defined by the Company as net income attributable to Entegris, Inc. before (1) net income attributable to noncontrolling interest, (2) equity in net income of affiliates, (3) income tax expense (4) other income, net, (5) interest (income) expense, net, (6) gain associated with pension curtailment, (7) charge associated with CEO succession and transition plan, (8) amortization of intangible assets and (9) depreciation. Adjusted Operating Income, another non-GAAP term, is defined by the Company as its Adjusted EBITDA less depreciation. The Company also utilizes non-GAAP measures whereby Adjusted EBITDA and Adjusted Operating Income are each divided by the Company s net sales to derive Adjusted EBITDA Margin and Adjusted Operating Margin, respectively.

Non-GAAP EPS, a non-GAAP term, is defined by the Company as net income attributable to Entegris, Inc. before (1) amortization of intangible assets, (2) accelerated write-off of debt issuance costs, (3) gain associated with equity investments, (4) gain associated with pension curtailment, (5) charge associated with CEO succession and transition plan, (6) the tax effect of the aforementioned adjustments to net income attributable to Entegris, Inc. and (7) reversal of deferred tax valuation allowance divided by weighted common shares outstanding.

The Company provides supplemental non-GAAP financial measures to better understand and manage its business and believes these measures provide investors and analysts additional and meaningful information for the assessment of the Company s ongoing results. Management also uses these non-GAAP measures to assist in the evaluation of the performance of its business segments and to make operating decisions.

Management believes the Company s non-GAAP measures help indicate the Company s baseline performance before certain gains, losses or other charges that may not be indicative of the Company s business or future outlook and offer a useful view of business performance in that the measures provide a more consistent means of comparing performance. The Company believes the non-GAAP measures aid investors overall understanding of the Company s results by providing a higher degree of transparency for such items and providing a level of disclosure that will help investors understand how management plans, measures and evaluates the Company s business performance. Management believes that the inclusion of non-GAAP measures provides consistency in its financial reporting and facilitates investors understanding of the Company s historical operating trends by providing an additional basis for comparisons to prior periods.

Management uses Adjusted EBITDA and Adjusted Operating Income to assist it in evaluations of the Company s operating performance by excluding items that management does not consider as relevant in the results of its ongoing operations. Internally, these non-GAAP measures are used by management for planning and forecasting purposes, including the preparation of internal budgets; for allocating resources to enhance financial performance; for evaluating the effectiveness of operational strategies; and for evaluating the Company s capacity to fund capital expenditures, secure financing and expand its business.

In addition, and as a consequence of the importance of these non-GAAP financial measures in managing its business, the Company s Board of Directors uses non-GAAP financial measures in the evaluation process to determine management compensation.

The Company believes that certain analysts and investors use Adjusted EBITDA, Adjusted Operating Income and non-GAAP EPS as supplemental measures to evaluate the overall operating performance of firms in the Company s industry. Additionally, lenders or potential lenders use Adjusted EBITDA measures to evaluate the Company s creditworthiness.

The presentation of non-GAAP financial measures is not meant to be considered in isolation, as a substitute for, or superior to, financial measures or information provided in accordance with GAAP. Management strongly encourages investors to review the Company s consolidated financial statements in their entirety and to not rely on any single financial measure.

Management notes that the use of non-GAAP measures has limitations:

First, non-GAAP financial measures are not standardized. Accordingly, the methodology used to produce the Company s non-GAAP financial measures is not computed under GAAP and may differ notably from the methodology used by other companies. For example, the Company s non-GAAP measure of Adjusted EBITDA may not be directly comparable to EBITDA or an adjusted EBITDA measure reported by other companies.

Second, the Company s non-GAAP financial measures exclude items such as amortization and depreciation that are recurring. Amortization of intangibles and depreciation have been, and will continue to be for the foreseeable future, a significant recurring expense with an impact upon the Company s results of operations, notwithstanding the lack of immediate impact upon cash flows.

Third, there is no assurance the Company will not have future restructuring activities, gains or losses on sale of equity investments, accelerated write-offs of debt-issuance costs or similar items and, therefore, may need to record additional charges (or credits) associated with such items, including the tax effects thereon. The exclusion of these items from the Company s non-GAAP measures should not be construed as an implication that these costs are unusual, infrequent or non-recurring.

Management considers these limitations by providing specific information regarding the GAAP amounts excluded from these non-GAAP financial measures and evaluating these non-GAAP financial measures together with their most directly comparable financial measures calculated in accordance with GAAP. The calculations of Adjusted EBITDA, Adjusted operating income, and non-GAAP EPS, and reconciliations between these financial measures and their most directly comparable GAAP equivalents are presented below in the accompanying tables.

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The reconciliation of GAAP measures to Adjusted Operating Income and Adjusted EBITDA for the years ended December 31, 2012 and 2011 are presented below:

(Dollars in thousands)	2012	2011
Net sales	$ 715,903	$ 749,259
Net income attributable to Entegris, Inc.	$ 68,825	$ 123,846
Adjustments to net income attributable to Entegris, Inc.		
Net income attributable to noncontrolling interest		400
Equity in net income of affiliates	(3)	(499)
Income tax expense	30,881	4,217
Other income, net	(249)	(1,745)
Interest (income) expense, net	(10)	659
GAAP Operating income	99,444	126,878
Gain associated with pension curtailment		(726)
Charge associated with CEO succession and transition plan	3,928	
Amortization of intangible assets	9,594	10,225
Adjusted operating income	112,966	136,377
Depreciation	28,013	26,839
Adjusted EBITDA	140,979	163,216
Adjusted operating margin	15.8%	18.2%
Adjusted EBITDA as a % of net sales	19.7%	21.8%

The reconciliation of GAAP measures to Non-GAAP Earnings per Share for the years ended December 31, 2012 and 2011 are presented below:

(Dollars in thousands)	2012	2011
GAAP net income attributable to Entegris, Inc.	$ 68,825	$ 123,846
Adjustments to net income attributable to Entegris, Inc.:		
Amortization of intangible assets	9,594	10,225
Accelerated write-off of debt issuance costs		282
Gain on sale of equity investment	(1,522)	(1,523)
Gain associated with pension curtailment		(726)
Charge associated with CEO succession and transition plan	3,928	
Tax effect of adjustments to net income attributable to Entegris, Inc.	(4,643)	(3,355)
Reversal of deferred tax valuation allowance[(1)]		(20,999)
Non-GAAP net income attributable to Entegris, Inc.	$ 76,182	$ 107,750
Diluted earnings per common share attributable to Entegris, Inc.	$ 0.50	$ 0.91
Effect of adjustments to net income attributable to Entegris, Inc.	$ 0.05	$ (0.12)
Diluted non-GAAP earnings per common share attributable to Entegris, Inc.:	$ 0.55	$ 0.79

(1) This amount represents the reversal of the remaining valuation allowance on certain of the Company s deferred tax assets. The amount excludes the reversal of the valuation allowance on those deferred tax assets realized in 2011 based on earnings in those years.

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Quantitative and Qualitative Disclosure About Market Risks

Entegris principal financial market risks are sensitivities to interest rates and foreign currency exchange rates. The Company s interest-bearing cash equivalents and short-term investments are subject to interest rate fluctuations. The Company s cash equivalents are instruments with maturities of three months or less. A 100 basis point change in interest rates would potentially increase or decrease annual net income by approximately $2.2 million annually.

The cash flows and results of operations of the Company s foreign-based operations are subject to fluctuations in foreign exchange rates. The Company occasionally uses derivative financial instruments to manage the foreign currency exchange rate risks associated with its foreign-based operations. At December 31, 2012, the Company had no net exposure to any foreign currency forward contracts.

Item 7a. Quantitative and Qualitative Disclosures about Market Risk.

The information required by this item can be found under the subcaption Quantitative and Qualitative Disclosure About Market Risks of Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7.

Item 8. Financial Statements and Supplementary Data.

The information called for by this item is set forth in the Consolidated Financial Statements covered by the Report of Independent Registered Public Accounting Firm at the end of this report.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.

This item is not applicable.

Item 9A. Controls and Procedures.
DISCLOSURE CONTROLS AND PROCEDURES

Management evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (the Exchange Act)), as of December 31, 2012, the end of the fiscal period covered by this report on Form 10-K. The Securities and Exchange Commission, or SEC, rules define the term disclosure controls and procedures to mean a company s controls and other procedures that are designed to ensure that information required to be disclosed in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in its reports filed under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Based on the evaluation of the effectiveness of our disclosure controls and procedures by our management team with the participation of the Chief Executive Officer and the Chief Financial Officer, our Chief Executive Officer and our Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC rules and forms and is accumulated and communicated to management, including the principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

(a) **MANAGEMENT S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Management is responsible for establishing and maintaining an adequate system of internal control over financial reporting of the Company. This system of internal financial reporting controls is designed to provide reasonable assurance that assets are safeguarded and transactions are properly recorded and executed in accordance with management s authorization. The design, monitoring and revision of the system of internal financial reporting controls involves, among other things, management s judgments with respect to the relative cost and expected benefits of specific control measures. The effectiveness of the control system is supported by the selection, retention and training of qualified personnel and an organizational structure that provides an appropriate division of responsibility and formalized procedures. The system of internal accounting controls is periodically reviewed and modified in response to changing conditions. Designated Company employees regularly monitor the adequacy and effectiveness of internal accounting controls.

Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Further, because of changes in conditions, the effectiveness of internal controls over financial reporting may vary over time. Our system contains control-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

Management conducted an evaluation of the effectiveness of the system of internal control over financial reporting based on the framework in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, management concluded that the Company s system of internal control over financial reporting was effective as of December 31, 2012.

KPMG LLP, the independent registered public accounting firm which audited the financial statements included in this annual report, has issued an attestation report on our internal control over financial reporting.

(b) **CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

There was no change in the Company s internal control over financial reporting during the most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, internal controls over financial reporting.

Item 9B. Other Information.

None.

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PART III

Item 10. Directors, Executive Officers and Corporate Governance.

The information called for by this item with respect to registrant s directors, including information relating to the independence of certain directors, identification of the audit committee and the audit committee financial expert, and with respect to corporate governance is set forth under the caption Proposal 1 Election of Directors and Corporate Governance , respectively, in the Company s definitive Proxy Statement for the Entegris, Inc. Annual Meeting of Stockholders to be held on May 8, 2013, and to be filed with the Securities and Exchange Commission on or about April 5, 2013, which information is hereby incorporated herein by reference.

The information called for by this item with respect to registrant s compliance with Section 16(a) of the Securities Exchange Act of 1934, as amended, is set forth under the caption Section 16(a) Beneficial Ownership Reporting Compliance in the Company s definitive Proxy Statement for the Entegris, Inc. Annual Meeting of Stockholders to be held on May 8, 2013, and to be filed with the Securities and Exchange Commission on or about April 5, 2013, which information is hereby incorporated herein by reference.

Information called for by this item with respect to registrant s executive officers is set forth under Executive Officers of the Registrant in Item 1 of this report.

At their first meeting following the Merger, on August 10, 2005, our Board of Directors adopted a code of business ethics, The Entegris, Inc. Code of Business Ethics, applicable to all of our executives, directors and employees as well as a set of corporate governance guidelines. The Entegris, Inc. Code of Business Ethics, the Corporate Governance Guidelines and the charters for our Audit & Finance Committee, Governance & Nominating Committee and our Management Development & Compensation Committee all appear on our website at http://www.Entegris.com under Investors Corporate Governance . The Entegris Code of Business Ethics, Corporate Governance Guidelines and committee charters are also available in print to any shareholder that requests a copy. Copies may be obtained by contacting Peter W. Walcott, our Senior Vice President, Secretary and General Counsel through our corporate headquarters. The Company intends to comply with the requirements of Item 5.05 of Form 8-K with respect to any amendment to or waiver of the provisions of the Entegris, Inc. Code of Business Ethics applicable to the registrant s Chief Executive Officer, Chief Financial Officer or Chief Accounting Officer by posting notice of any such amendment or waiver at the same location on our website.

Item 11. Executive Compensation.

The information called for by this item is set forth under the caption Compensation of Executive Officers and Management Development & Compensation Committee Report , respectively, in the Company s definitive Proxy Statement for the Entegris, Inc. Annual Meeting of Stockholders to be held on May 8, 2013, and to be filed with the Securities and Exchange Commission on or about April 5, 2013, which information is hereby incorporated herein by reference.

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Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.
Securities Authorized for Issuance Under Equity Compensation Plans:

As of December 31, 2012, our equity compensation plan information is as follows:

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	4,367,489	$ 8.20[1]	7,655,166[2]
Equity compensation plans not approved by security holders			
Total	4,367,489	$ 8.20	7,655,166

(1) The weighted average exercise price does not take into account the shares issuable upon outstanding restricted stock unit vesting, which have no exercise price.

(2) These shares are available under the 2010 Stock Plan for future issuance for stock options, restricted stock units, performance shares and stock awards in accordance with the terms of the 2010 Stock Plan.

The other information called for by this item is set forth under the caption Ownership of Entegris Common Stock in the Company s definitive Proxy Statement for the Entegris, Inc. Annual Meeting of Stockholders to be held on May 8, 2013, and to be filed with the Securities and Exchange Commission on or about April 5, 2013, which information is hereby incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

The information called for by this item with respect to certain transactions and relationships between the registrant and directors, executive officers and five percent stockholders is set forth under the caption Corporate Governance in the Company s definitive Proxy Statement for the Entegris, Inc. Annual Meeting of Stockholders to be held on May 8, 2013, and to be filed with the Securities and Exchange Commission on or about April 5, 2013, which information is hereby incorporated herein by reference.

Item 14. Principal Accountant Fees and Services.

The information called for by this item with respect to the fees paid to and the services performed by the registrant s principal accountant is set forth under the caption Proposal 2 Ratification of Selection of Independent Registered Public Accounting Firm for 2013 in the Company s definitive Proxy Statement for the Entegris, Inc. Annual Meeting of Stockholders to be held on May 8, 2013, and to be filed with the Securities and Exchange Commission on or about April 5, 2013, which information is hereby incorporated herein by reference.

PART IV

Item 15. Exhibits and Financial Statement Schedules.

(a) The following documents are filed as a part of this report:

1. **Financial Statements.** The Consolidated Financial Statements listed under Item 8 of this report and in the Index to Consolidated Financial Statements on page F-1 of this report are incorporated by reference herein.

2. **Exhibits.**

A. The following exhibits are incorporated by reference:

Reg. S-K Item 601(b) Reference	Document Incorporated	Referenced Document on file with the Commission
(2)	Agreement and Plan of Merger, dated as of March 21, 2005, by and among Entegris, Inc., Mykrolis Corporation and Eagle DE, Inc.	Included as Annex B in the joint proxy statement/prospectus included in S-4 Registration Statement of Entegris, Inc. and Eagle DE, Inc. (No. 333-124719)
(2)	Agreement and Plan of Merger, dated as of March 21, 2005, by and between Entegris, Inc., and Eagle DE, Inc.	Included as Annex B in the joint proxy statement/prospectus included in S-4 Registration Statement of Entegris, Inc. and Eagle DE, Inc. (No. 333-124719)
(3)	By-Laws of Entegris, Inc., as amended December 17, 2008	Exhibit 3 to Entegris, Inc. Annual Report on Form 10-K for the fiscal year ended December 31, 2008
(3)	Amended and Restated Certificate of Incorporation of Entegris, Inc., as amended	Exhibit 3.1 to Entegris, Inc. Annual Report on Form 10-K for the fiscal year ended December 31, 2011
(4)	Form of certificate representing shares of Common Stock, $.01 par value per share	Exhibit 4.1 to Form S-4 Registration Statement of Entegris, Inc. and Eagle DE, Inc. (No. 333-124719)

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(4)	Rights Agreement dated July 26, 2005 between Entegris and Wells Fargo Bank, N.A as rights agent	Exhibit 4.1 to Entegris, Inc. (Entegris Minnesota) Current Report on Form 8-K filed with the Securities and Exchange Commission on July 29, 2005
(10)	Entegris, Inc. 2010 Stock Plan, as amended*	Exhibit 10.1 to Entegris, Inc. Quarterly Report on Form 10-Q for the period ended July 3, 2010
(10)	Entegris, Inc. Outside Directors Stock Option Plan*	Exhibit 10.2 to Entegris, Inc. Registration Statement on Form S-1 (No. 333-33668)
(10)	Entegris, Inc. 2000 Employee Stock Purchase Plan*	Exhibit 10.3 to Entegris, Inc. Registration Statement on Form S-1 (No. 333-33668)
(10)	Amended and Restated Entegris Incentive Plan*	Exhibit 10.1 to Entegris, Inc. Quarterly Report on Form 10-Q for the period ended June 28, 2008
(10)	Lease Agreement, dated April 1, 2002 between Nortel Networks HPOCS Inc. and Mykrolis Corporation, relating to Executive office, R&D and manufacturing facility located at 129 Concord Road Billerica, MA	Exhibit 10.1.3 to Mykrolis Corporation s Quarterly Report on Form 10-Q for the quarter ended March 31, 2002
(10)	Amendment of Lease between Entegris, Inc. and KBS Rivertech, LLC dated April 1, 2012	Exhibit 10.1 to Entegris, Inc. Quarterly Report on Form 10-Q for the period ended June 30, 2012
(10)	Amended and Restated Employment Agreement, dated as of May 4, 2005, by and between Mykrolis Corporation and Gideon Argov*	Exhibit 10.13 to Mykrolis Corporation s Quarterly Report on Form 10-Q for the quarter ended April 2, 2005
(10)	Fluoropolymer Purchase and Sale Agreement, by and between E.I. Du Pont De Nemours and Company and the Registrant, dated January 1, 2011, as amended	Exhibit 10.2 to Entegris, Inc. Quarterly Report on Form 10-Q for the quarter ended April 2, 2011
(10)	Credit Agreement, dated June 9, 2011, among Entegris, Inc., Poco Graphite, Inc., the Lenders (as defined therein) and Wells Fargo Bank, NA, as Administrative Agent.	Exhibit 10.1 to Entegris, Inc. Quarterly Report on Form 10-Q for the period ended July 2, 2011

(10)	First Amendment to Credit Agreement, dated August 1, 2012, among the Registrant, Poco Graphite, Inc., the Lenders as defined in the Credit Agreement and Wells Fargo Bank National Association	Exhibit 99.1 to Entegris, Inc. Current Report on Form 8-K filed on August 3, 2012
(10)	Form of Indemnification Agreement between Entegris, Inc. and each of its executive officers and Directors	Exhibit 10.30 to Entegris, Inc. Annual Report on Form 10-K for the fiscal year ended August 27, 2005
(10)	Form of Executive Change of Control Termination Agreement between Entegris, Inc. and certain of its executive officers*	Exhibit 10.31 to Entegris, Inc. Annual Report on Form 10-K for the fiscal year ended August 27, 2005
(10)	Severance Protection Agreement, dated July 26, 2011 between Entegris, Inc. and Gregory B. Graves*	Exhibit 10.2 to Entegris, Inc. Quarterly Report on Form 10-Q for the period ended July 2, 2011
(10)	Trust Agreement between Entegris, Inc. Fidelity Management Trust Company and Entegris Inc. 401(k) Savings and Profit Sharing Plan Trust, dated December 29, 2007.	Exhibit 10.3 to Entegris, Inc. Annual Report on Form 10-K for the fiscal year ended December 31, 2007
(10)	Entegris, Inc. 2007 Deferred Compensation Plan*	Exhibit 10.2 to Entegris, Inc. Quarterly Report on Form10-Q for the fiscal period ended June 30, 2007
(10)	Entegris, Inc. Form of 2010 RSU Unit Award Agreement*	Exhibit 10.1 to Entegris, Inc. Quarterly Report on Form 10-Q for the fiscal period ended April 3, 2010
(10)	Entegris, Inc. Form of 2010 Stock Option Award Agreement*	Exhibit 10.1 to Entegris, Inc. Quarterly Report on Form 10-Q for the fiscal period ended April 3, 2010
(10)	Fourth Amended and Restated Membrane Manufacture and Supply Agreement, dated January 10, 2011, by and between Entegris, Inc. and Millipore Corporation.	Exhibit 10.1 to Entegris, Inc. Quarterly Report on Form 10-Q for the fiscal period ended April 2, 2011
(10)	Amended and Restated Supplemental Executive Retirement Plan for Key Salaried Employees*	Exhibit 10.2 to Entegris, Inc. Annual Report on Form 10-K for the fiscal year ended December 31, 2008

(10)	Amendment to Amended and Restated SERP*	Exhibit 10.15 to Entegris, Inc. Annual Report on Form 10-K for the fiscal year ended December 31, 2009.
(10)	Entegris, Inc. 2012 RSU Unit Award Agreement*	Exhibit 10.2 to Entegris, Inc. Quarterly Report on Form 10-Q for the fiscal period ended March 31, 2012
(10)	Entegris, Inc. 2012 Stock Option Grant Agreement*	Exhibit 10.3 to Entegris, Inc. Quarterly Report on Form 10-Q for the fiscal period ended March 31, 2012
(10)	Entegris, Inc. 401(k) Savings and Profit Sharing Plan (2012 Restatement)*	Exhibit 10.2 to Entegris, Inc. Quarterly Report on Form 10-Q for the fiscal period ended March 31, 2012

* A management contract or compensatory plan

B. The Company hereby files as exhibits to this Annual Report on Form 10-K the following documents:

Reg. S-K

Item 601(b)

Reference	Exhibit No.	Documents Filed Herewith
(10)	10.1	Executive Employment Agreement, effective November 28, 2012, between the Registrant and Bertrand Loy*
(10)	10.2	2011 RSU Unit Award Agreement*
(10)	10.3	2011 Stock Option Award Agreement*
(21)	21	Subsidiaries of Entegris, Inc.
(23)	23	Consent of Independent Registered Public Accounting Firm
(24)	24	Power of Attorney by the Directors of Entegris, Inc.
(31)	31.1	Certification required by Rule 13a-14(a) in accordance with Section 302 of the Sarbanes Oxley Act of 2002.
(31)	31.2	Certification required by Rule 13a-14(a) in accordance with Section 302 of the Sarbanes Oxley Act of 2002.
(32)	32.1	Certification required by Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
(32)	32.2	Certification required by Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
(101)	101.1	Interactive data files pursuant to Rule 405 of Regulation S-T, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets at December 31, 2012 and 2011, (ii) the Consolidated Statement of Operations for the years ended December 31, 2012, 2011 and 2010, (iii) the Consolidated Statements of Equity for the years ended December 31, 2012, 2011 and 2010, (iv) the Consolidated Statements of Comprehensive Income for the years ended December 31, 2012, 2011 and 2010, (v) the Consolidated Statement of Cash Flows for the years ended December 31, 2012, 2011 and 2010 and (vi) the notes to the Consolidated Financial Statements.**

* A management contract or compensatory plan

** In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Annual Report on Form 10-K is deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise is not subject to liability under those sections.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ENTEGRIS, INC.

Dated: February 22, 2013

By /s/ BERTRAND LOY
Bertrand Loy
President & Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

SIGNATURE	TITLE	DATE
/s/ BERTRAND LOY Bertrand Loy	President, Chief Executive Officer and Director (Principal executive officer)	February 22, 2013
/s/ GREGORY B. GRAVES Gregory B. Graves	Executive Vice President, Chief Financial Officer & Treasurer (Principal financial officer)	February 22, 2013
/s/ MICHAEL D. SAUER Michael D. Sauer	Vice President, Controller & Chief Accounting Officer (Principal accounting officer)	February 22, 2013
PAUL L.H. OLSON* Paul L.H. Olson	Director, Chairman of the Board	February 22, 2013
MICHAEL A. BRADLEY* Michael A. Bradley	Director	February 22, 2013
MARVIN D. BURKETT* Marvin D. Burkett	Director	February 22, 2013
R. NICHOLAS BURNS* R. Nicholas Burns	Director	February 22, 2013
DANIEL W. CHRISTMAN* Daniel W. Christman	Director	February 22, 2013
ROGER D. MCDANIEL * Roger D. McDaniel	Director	February 22, 2013
BRIAN F. SULLIVAN* Brian F. Sullivan	Director	February 22, 2013

*By /s/ BERTRAND LOY
BERTRAND LOY, ATTORNEY-IN-FACT

EXHIBIT INDEX

Reg. S-K Item 601(b)

Reference	Exhibit No.	Documents Filed Herewith
(10)	10.1	Executive Employment Agreement, effective November 28, 2012, between the Registrant and Bertrand Loy*
(10)	10.2	2011 RSU Unit Award Agreement*
(10)	10.3	2011 Stock Option Award Agreement*
(21)	21	Subsidiaries of Entegris, Inc.
(23)	23	Consent of Independent Registered Public Accounting Firm
(24)	24	Power of Attorney by the Directors of Entegris, Inc.
(31)	31.1	Certification required by Rule 13a-14(a) in accordance with Section 302 of the Sarbanes Oxley Act of 2002.
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(101)	101.1	Interactive data files pursuant to Rule 405 of Regulation S-T, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets at December 31, 2012 and 2011, (ii) the Consolidated Statement of Operations for the years ended December 31, 2012, 2011 and 2010, (iii) the Consolidated Statements of Equity for the years ended December 31, 2012, 2011 and 2010, (iv) the Consolidated Statements of Comprehensive Income for the years ended December 31, 2012, 2011 and 2010, (v) the Consolidated Statement of Cash Flows for the years ended December 31, 2012, 2011 and 2010 and (vi) the notes to the Consolidated Financial Statements.**

* A management contract or compensatory plan

** In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Annual Report on Form 10-K is deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise is not subject to liability under those sections.

ENTEGRIS, INC.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Entegris, Inc.:

We have audited the accompanying consolidated balance sheets of Entegris, Inc. and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income, equity, and cash flows for each of the years in the three-year period ended December 31, 2012. We also have audited Entegris, Inc. s internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Entegris, Inc. s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 9A.(b) *Management s Annual Report on Internal Control Over Financial Reporting*. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Entegris, Inc. and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles. Also in our opinion, Entegris, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ KPMG LLP

Minneapolis, Minnesota

February 22, 2013

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ENTEGRIS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)	December 31, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 330,419	$ 273,593
Short-term investments	19,995	
Trade accounts and notes receivable, net	94,016	107,223
Inventories, net	99,144	93,937
Deferred tax assets, deferred tax charges and refundable income taxes	20,201	15,805
Assets held for sale	5,998	5,998
Other current assets	9,551	6,443
Total current assets	579,324	502,999
Property, plant and equipment, net	157,021	130,554
Other assets:		
Intangible assets, net	47,207	56,453
Deferred tax assets and other noncurrent tax assets	17,167	25,119
Other	10,825	9,538
Total assets	$ 811,544	$ 724,663
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	$ 36,341	$ 30,609
Accrued payroll and related benefits	29,376	30,887
Other accrued liabilities	21,887	16,954
Deferred tax liabilities and income taxes payable	5,659	14,144
Total current liabilities	93,263	92,594
Pension benefit obligations and other liabilities	17,066	19,868
Deferred tax liabilities and other noncurrent tax liabilities	6,416	3,963
Commitments and contingent liabilities		
Equity:		
Preferred stock, par value $.01; 5,000,000 shares authorized; none issued and outstanding as of December 31, 2012 and 2011		
Common stock, par value $.01; 400,000,000 shares authorized; issued and outstanding shares: 138,457,769 and 135,820,588	1,385	1,358
Additional paid-in capital	809,514	788,673
Retained deficit	(157,038)	(225,766)
Accumulated other comprehensive income	40,938	43,973
Total equity	694,799	608,238
Total liabilities and equity	$ 811,544	$ 724,663

See the accompanying notes to consolidated financial statements.

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ENTEGRIS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)	Year ended December 31, 2012	Year ended December 31, 2011	Year ended December 31, 2010
Net sales	$ 715,903	$ 749,259	$ 688,416
Cost of sales	408,520	423,329	377,773
Gross profit	307,383	325,930	310,643
Selling, general and administrative expenses	147,405	140,847	147,051
Engineering, research and development expenses	50,940	47,980	43,934
Amortization of intangible assets	9,594	10,225	13,231
Operating income	99,444	126,878	106,427
Interest expense	271	886	3,598
Interest income	(281)	(227)	(82)
Other (income) expense, net	(249)	(1,745)	1,430
Income before income taxes and equity in net (income) loss of affiliates	99,703	127,964	101,481
Income tax expense	30,881	4,217	15,006
Equity in net (income) loss of affiliates	(3)	(499)	1,353
Net income	68,825	124,246	85,122
Less net income attributable to the noncontrolling interest		400	766
Net income attributable to Entegris, Inc.	$ 68,825	$ 123,846	$ 84,356
Amounts attributable to Entegris, Inc.:			
Basic net income per common share	$ 0.50	$ 0.92	$ 0.64
Diluted net income per common share	$ 0.50	$ 0.91	$ 0.63
Weighted shares outstanding			
Basic	137,306	134,685	131,685
Diluted	138,412	136,223	133,174

See the accompanying notes to consolidated financial statements.

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ENTEGRIS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)	Year ended December 31, 2012	Year ended December 31, 2011	Year ended December 31, 2010
Net income	$ 68,825	$ 124,246	$ 85,122
Other comprehensive income, net of tax			
Foreign currency translation adjustments	(2,524)	925	15,535
Reclassification of cumulative translation adjustment associated with sale of equity method investee		(1,715)	
Reclassification of cumulative translation adjustment associated with acquisition of business	(216)		
Pension liability adjustments, net of income tax expense of $74, $1,631, and $330 for year ended December 31, 2012, 2011, and 2010	(295)	2,386	(837)
Other comprehensive income	(3,035)	1,596	14,698
Comprehensive income	65,790	125,842	99,820
Less comprehensive income attributable to the noncontrolling interest		620	929
Comprehensive income attributable to Entegris, Inc.	$ 65,790	$ 125,222	$ 98,891

See the accompanying notes to consolidated financial statements

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ENTEGRIS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EQUITY

(In thousands)	Common shares outstanding	Common stock	Additional paid-in capital	Retained earnings (deficit)	Accumulated other comprehensive income (loss)	Noncontrolling interest	Total
Balance at December 31, 2009	130,043	$ 1,300	$ 751,360	$ (433,968)	$ 27,500	$ 3,465	$ 349,657
Shares issued under stock plans	2,858	29	6,770				6,799
Share-based compensation expense			7,588				7,588
Tax benefit associated with stock plans			149				149
Pension liability adjustment					(837)		(837)
Foreign currency translation					15,372	163	15,535
Net income				84,356		766	85,122
Balance at December 31, 2010	132,901	1,329	765,867	(349,612)	42,035	4,394	464,013
Shares issued under stock plans	2,920	29	11,661				11,690
Share-based compensation expense			7,519				7,519
Tax benefit associated with stock plans			657				657
Purchase of noncontrolling interest			2,969		562	(5,014)	(1,483)
Pension liability adjustment					2,386		2,386
Reclassification of cumulative translation adjustment associated with sale of equity method investee					(1,715)		(1,715)
Foreign currency translation					705	220	925
Net income				123,846		400	124,246
Balance at December 31, 2011	135,821	1,358	788,673	(225,766)	43,973		608,238
Shares issued under stock plans	2,694	28	7,403				7,431
Share-based compensation expense			9,881				9,881
Repurchase and retirement of common stock	(57)	(1)	(329)	(97)			(427)
Tax benefit associated with stock plans			3,886				3,886
Pension liability adjustment					(295)		(295)
Reclassification of foreign currency translation associated with acquisition of business					(216)		(216)
Foreign currency translation					(2,524)		(2,524)
Net income				68,825			68,825
Balance at December 31, 2012	138,458	$ 1,385	$ 809,514	$ (157,038)	$ 40,938		$ 694,799

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ENTEGRIS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)	Year ended December 31, 2012	Year ended December 31, 2011	Year ended December 31, 2010
Operating activities:			
Net income	$ 68,825	$ 124,246	$ 85,122
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	28,013	26,839	27,967
Amortization	9,594	10,225	13,231
Share-based compensation expense	9,881	7,519	7,588
Impairment of equity investments			2,164
Deferred tax valuation allowance	358	(41,038)	(13,600)
Provision for deferred income taxes	11,582	21,671	10,647
Charge for excess and obsolete inventory	4,007	3,167	998
Excess tax benefit from share-based compensation plans	(3,805)	(657)	(149)
Amortization of debt issuance costs		676	1,731
Net income attributable to noncontrolling interest		(400)	(766)
Other	1,701	(2,245)	(1,302)
Changes in operating assets and liabilities, net of effects of acquisitions:			
Trade accounts receivable and notes receivable	10,626	19,336	(26,789)
Inventories	(6,118)	3,632	(14,285)
Accounts payable and accrued liabilities	6,265	(15,127)	34,860
Other current assets	(2,985)	1,253	(283)
Income taxes payable and refundable income taxes	(11,015)	(433)	13,243
Other	(11,767)	(1,378)	521
Net cash provided by operating activities	115,162	157,286	140,898
Investing activities:			
Acquisition of property and equipment	(49,929)	(30,267)	(16,794)
Purchase of short-term investments	(27,990)	(2,047)	
Proceeds from sale or maturities of short-term investments	8,000	2,000	
Other	(2,548)	1,883	4,809
Net cash used in investing activities	(72,467)	(28,431)	(11,985)
Financing activities:			
Principal payments on short-term borrowings and long-term debt			(259,157)
Proceeds from short-term borrowings and long-term debt			186,649
Issuance of common stock from employee stock plans	7,431	11,690	6,799
Other	3,459	(826)	
Net cash provided by (used in) financing activities	10,890	10,864	(65,709)
Effect of exchange rate changes on cash and cash equivalents	3,241	(80)	2,050
Increase in cash and cash equivalents	56,826	139,639	65,254
Cash and cash equivalents at beginning of period	273,593	133,954	68,700
Cash and cash equivalents at end of period	$ 330,419	$ 273,593	$ 133,954

Supplemental Cash Flow Information

(In thousands)	Year ended December 31, 2012	Year ended December 31, 2011	Year ended December 31, 2010
Non-cash transactions:			
Equipment purchases in accounts payable	$ 3,429	$ 1,372	$ 517
Intangible assets received as partial consideration in sale of equity interest		1,712	
Schedule of interest and income taxes paid:			
Interest paid	$ 271	$ 210	$ 2,072
Income taxes, net of refunds received	29,697	22,034	3,592

See accompanying notes to consolidated financial statements.

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ENTEGRIS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations Entegris, Inc. (Entegris or the Company) is a leading provider of products and services that purify, protect and transport the critical materials used in key technology-driven industries, primarily the semiconductor and related industries.

Principles of Consolidation The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. Intercompany profits, transactions and balances have been eliminated in consolidation.

Use of Estimates The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make judgments, estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. On an ongoing basis, Entegris evaluates its estimates, including those related to receivables, inventories, property, plant and equipment, intangible assets, accrued expenses, income taxes and share-based compensation, among others. Actual results could differ from those estimates.

Concentrations of Suppliers Certain materials included in the Company s products are obtained from a single source or a limited group of suppliers. Although the Company seeks to reduce dependence on those sole and limited source suppliers, the partial or complete loss of these sources could have at least a temporary adverse effect on the Company s results of operations. Furthermore, a significant increase in the price of one or more of these components could adversely affect the Company s results of operations.

Cash and Cash Equivalents Cash and cash equivalents include cash on hand and highly liquid debt securities with original maturities of three months or less, which are valued at cost which approximates fair value.

Allowance for Doubtful Accounts An allowance for uncollectible trade receivables is estimated based on a combination of write-off history, aging analysis and any specific, known troubled accounts. The Company maintains an allowance for doubtful accounts that management believes is adequate to cover expected losses on trade receivables.

Inventories Inventories are stated at the lower of cost or market. Cost is determined by the first-in, first-out (FIFO) method.

Property, Plant, and Equipment Property, plant and equipment are carried at cost and are depreciated on the straight-line method over the estimated useful lives of the assets. When assets are retired or disposed of, the cost and related accumulated depreciation are removed from the accounts, and gains or losses are recognized in the same period. Maintenance and repairs are expensed as incurred; significant additions and improvements are capitalized. Long-lived assets, including property, plant and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or group of asset(s) may not be recoverable based on estimated future undiscounted cash flows. The amount of impairment, if any, is measured as the difference between the net book value and the estimated fair value of the asset(s).

Investments The Company s nonmarketable investments are accounted for under either the cost or equity method of accounting, as appropriate. All nonmarketable investments are periodically reviewed to determine whether declines, if any, in fair value below cost basis are other-than-temporary. If the decline in fair value is determined to be other-than-temporary, an impairment loss is recorded and the investment written down to a new cost basis.

Fair Value of Financial Instruments The carrying value of cash equivalents, accounts receivable and accounts payable approximates fair value due to the short maturity of those instruments.

Intangible Assets Amortizable intangible assets include, among other items, patents, unpatented and other developed technology and customer-based intangibles, and are amortized using the straight-line method over their respective estimated useful lives of 3 to 15 years. The Company reviews intangible assets, along with other long-lived assets, for impairment if changes in circumstances or the occurrence of events suggest the remaining value may not be recoverable.

Derivative Financial Instruments The Company records derivatives as assets or liabilities on the balance sheet and measures such instruments at fair value. Changes in fair value of derivatives are recorded each period in current results of operations or other comprehensive income.

The Company periodically enters into forward foreign currency contracts to reduce exposures relating to rate changes in certain foreign currencies. Certain exposures to credit losses related to counterparty nonperformance exist. However, the Company does not anticipate nonperformance by the counterparties since they are large, well-established financial institutions. None of these derivatives is accounted for as a hedge transaction. Accordingly, changes in the fair value of forward foreign currency contracts are recorded as other (income) expense, net in the Company s statement of operations. The fair values of the Company s derivative financial instruments are based on prices quoted by financial institutions for these instruments. The Company had no net exposure to any forward contracts at December 31, 2012 and December 31, 2011.

Foreign Currency Translation Assets and liabilities of foreign subsidiaries are generally translated from foreign currencies into U.S. dollars at period-end exchange rates, and the resulting gains and losses arising from translation of net assets located outside the U.S. are recorded as a cumulative translation adjustment, a component of accumulated other comprehensive income (loss) in the consolidated balance sheets. Income statement amounts are translated at the weighted average exchange rates for the year. Translation adjustments are not adjusted for income taxes as substantially all translation adjustments relate to permanent investments in non-U.S. subsidiaries. Gains and losses resulting from foreign currency transactions are included in other income, net in the consolidated statements of operations.

Revenue Recognition Revenue and the related cost of sales are generally recognized upon shipment of the products. Revenue for product sales is recognized upon delivery, when persuasive evidence of an arrangement exists, when title and risk of loss have been transferred to the customer, collectability is reasonably assured, and pricing is fixed or determinable. Shipping and handling fees related to sales transactions are billed to customers and are recorded as sales revenue.

The Company sells its products throughout the world primarily to companies in the microelectronics industry. The Company performs continuing credit evaluations of its customers and generally does not require collateral. Letters of credit may be required from its customers in certain circumstances. The Company provides for estimated returns when the revenue is recorded based on historical and current trends in both sales and product returns.

The Company collects various sales and value-added taxes on certain product and service sales that are accounted for on a net basis.

Shipping and handling costs Shipping and handling costs incurred are recorded in cost of sales in the consolidated statements of operations.

Engineering, research and development expenses Engineering, research and development expenses costs are expensed as incurred.

Share-based Compensation The Company measures the cost of employee services received in exchange for the award of equity instruments based on the fair value of the award at the date of grant. The cost is recognized over the period during which an employee is required to provide services in exchange for the award. Compensation expense is based on the grant date fair value. Because share-based compensation expense recognized in the consolidated statements of operations for the years ended December 31, 2012, 2011 and 2010 is based on awards ultimately expected to vest, it has been reduced for expected forfeitures which are estimated at the time of grant with such estimates revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Income Taxes The Company accounts for income taxes under the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements. Under this method, deferred tax assets and liabilities are determined on the basis of the differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date.

The Company recognizes deferred tax assets to the extent that it believes these assets are more likely than not to be realized. A valuation allowance is recorded to reduce deferred tax assets when it is more likely than not that the Company would not be able to realize all or part of its deferred tax assets. In making such a determination, the Company considers all available positive and negative evidence, including future reversals of existing temporary differences, projected future taxable income, tax-planning strategies, and results of recent operations. If the Company determines that it would be able to realize its deferred tax assets in the future in excess of their net recorded amount, the Company would make an adjustment to the deferred tax asset valuation allowance, which would reduce the provision for income taxes.

The Company s policy for recording interest and penalties associated with audits and unrecognized tax benefits is to record such items as a component of income before taxes. Penalties are recorded in other (income) expense, net and interest to be paid or received is recorded in interest expense or interest income, respectively, in the statement of operations.

Comprehensive Income Comprehensive income represents the change in equity resulting from items other than shareholder investments and distributions. The Company s foreign currency translation adjustments and minimum pension liability adjustments are included in accumulated other comprehensive income. Comprehensive income and the components of accumulated other comprehensive income are presented in the accompanying consolidated statements of equity and comprehensive income.

Recent Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-05, *Presentation of Comprehensive Income,* which requires entities to present reclassification adjustments included in other comprehensive income on the face of the financial statements and allows entities to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. It also eliminates the option for entities to present the components of other comprehensive income as part of the statement of changes in stockholders equity. ASU No. 2011-05 was effective for the Company in the first quarter of 2012. Adoption of this ASU relates to the presentation of financial information and had no effect on the Company s consolidated financial position or results of operations.

(2) ACQUISITIONS

Acquisition of Pureline Co., Ltd.

In 2007, the Company acquired a 40% ownership interest in Pureline Co., Ltd. (Pureline), a privately held company located in Munmak, South Korea and manufacturer of fluid handling products. The Company accounted for its interest in Pureline under the equity method of accounting. Concurrent with its 2007 investment in Pureline, the Company obtained two options, each to purchase 30% of the remaining outstanding shares of Pureline based upon a multiple of Pureline s calendar 2008 and 2009 adjusted earnings, respectively, by July 31 of the subsequent year.

On July 31, 2009, the Company exercised the first of its options and acquired an additional 30% equity interest in Pureline as described below. As of the date of the exercise, the Company owned a 70% controlling interest in Pureline. Accordingly, the transaction was accounted for under the acquisition method of accounting and the results of operations of Pureline are included in the Company s consolidated financial statements as of and since July 31, 2009. Pureline s sales and operating results for the five months ended December 31, 2009 were not material to the Company s consolidated financial statements.

The Company remeasured its previously held equity interest in Pureline at its July 31, 2009 fair value. The July 31, 2009 fair value of the equity interest in Pureline held by the Company before the acquisition date was $4.3 million. Based on the carrying value of the Company s equity interest in Pureline before the business combination, the Company recognized a gain of $0.2 million in earnings. In prior reporting periods, the Company recognized changes in the value of its equity interest in Pureline related to translation adjustments in other comprehensive loss. Accordingly, the $0.8 million recognized previously in other comprehensive loss was reclassified and included in the calculation of the charge to earnings.

In connection with the transaction, the Company measured and recorded the fair value of the 30% noncontrolling interest in Pureline. The fair value of the noncontrolling interest in Pureline at July 31, 2009 was $3.2 million.

During the second quarter ended July 3, 2010, the Company received proceeds of $3.6 million from the South Korean government in connection with eminent domain proceedings whereby the Company relinquished its existing land and building to the government upon the completion of a new facility in South Korea. The new building was completed in the fourth quarter of 2010 and the previously occupied building and land were relinquished in 2011 to the South Korean government.

On April 4, 2011, the Company exercised the second option and purchased the 30% noncontrolling interest in Pureline for $1.483 million. Based on the carrying value of the Company s noncontrolling interest in Pureline as of the date of the transaction, the Company recorded increases to additional paid-in capital and accumulated other comprehensive income as reflected in the Company s consolidated statements of equity. The cash outflow is reflected as a financing activity in the Company s consolidated statements of cash flows.

(3) SHORT-TERM INVESTMENTS

Available-for-sale investments as of December 31, 2012 were as follows:

(In thousands)	Cost basis	Gross unrealized gains	Gross unrealized losses	Fair value
Commercial paper	$ 19,999	$	$ (4)	$ 19,995
Total available-for-sale investments	$ 19,999	$	$ (4)	$ 19,995

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Investments with continuous unrealized losses for less than 12 months and their related fair values as of December 31, 2012 were as follows:

	Less than 12 months	
(In thousands)	Fair value	Gross unrealized losses
Commercial paper	$ 19,995	$ (4)
Total	$ 19,995	$ (4)

Unrealized losses from corporate bonds are primarily attributable to general changes in interest rates and market conditions. Management does not believe the unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence as of December 31, 2012.

The amortized cost and fair value of available-for-sale debt investments as of December 31, 2012, by contractual maturity, were as follows:

(In thousands)	Cost basis	Fair value
Due in 1 year or less	$ 19,999	$ 19,995
Total	$ 19,999	$ 19,995

The net unrealized holding gains (losses) on available-for-sale investments that have been included in other comprehensive income (loss) and the net gains (losses) reclassified from accumulated other comprehensive income (loss) into earnings for the year ended December 31, 2012 were as follows:

(In thousands)	2012
Net unrealized holding losses included in other comprehensive income	$ (4)
Net gains (losses) reclassified from accumulated other comprehensive income (loss) into earnings	$

(4) TRADE ACCOUNTS AND NOTES RECEIVABLE

Trade accounts and notes receivable from customers at December 31, 2012 and 2011 consist of the following:

(In thousands)	2012	2011
Accounts receivable	$ 86,717	$ 95,890
Notes receivable	9,613	12,370
	96,330	108,260
Less allowance for doubtful accounts	2,314	1,037
	$ 94,016	$ 107,223

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(5) INVENTORIES

Inventories at December 31, 2012 and 2011 consist of the following:

(In thousands)	2012	2011
Raw materials	$ 27,720	$ 26,385
Work-in-process	10,242	12,258
Finished goods [(a)]	60,667	54,688
Supplies	515	606
	$ 99,144	$ 93,937

(a) Includes consignment inventories held by customers for $5,229 and $5,157 at December 31, 2012 and 2011, respectively.

(6) PROPERTY, PLANT AND EQUIPMENT

Property, plant, and equipment at December 31, 2012 and 2011 consist of the following:

(In thousands)	2012	2011	Estimated useful lives in years
Land	$ 11,065	$ 11,548	
Buildings and improvements	85,239	75,603	5-35
Manufacturing equipment	151,559	141,206	5-10
Molds	79,959	72,536	3-5
Office furniture and equipment	65,950	61,064	3-8
Construction in progress	26,551	7,285	
	420,323	369,242	
Less accumulated depreciation	263,302	238,688	
	$ 157,021	$ 130,554	

The table below sets forth the depreciation expense for the years ended December 31, 2012, 2011, and 2010:

(In thousands)	2012	2011	2010
Depreciation expense	$ 28,013	$ 26,839	$ 27,967

(7) INVESTMENTS

At December 31, 2012 and 2011, the Company held equity investments totaling $2.4 million and $3.8 million, respectively. These investments all represent interests in privately held companies. All investments at December 31, 2012 are accounted for under the cost method.

During 2012, the Company acquired the remaining 50% of Entegris Precision Technologies Corporation (EPT) in Taiwan, an entity in which it had previously owned a 50% equity interest accounted for under the equity method. The transaction was accounted for under the acquisition method of accounting and the results of operations of the entity are included in the Company s consolidated financial statements as of and since April 2, 2012. The investee s sales and operating results are not material to the Company s consolidated financial statements. The Company paid $3.4 million in cash for the additional 50% equity interest in the entity. A detailed description of the transaction can be found in Note 14 under

the heading Items Measured at Fair Value on a Nonrecurring Basis .

During 2011, the Company recorded a gain of $1.5 million on the sale of an equity method investment that was classified within other (income) expense, net in the consolidated statements of operations. A detailed description of the transaction can be found in Note 14 under the heading Items Measured at Fair Value on a Nonrecurring Basis .

During 2010, the Company determined that one of its investments was partially impaired. The Company recorded an impairment loss of $2.2 million that was classified in equity in net loss of affiliates in the statement of operations. Also in 2010, the Company sold two of its equity investments for $0.9 million. The Company recorded gains of $0.9 million that were classified within other (income) expense, net in the consolidated results of operations.

(8) INTANGIBLE ASSETS

Intangible assets at December 31, 2012 and 2011 consist of the following:

(In thousands)	2012 Gross carrying Amount	Accumulated amortization	Net carrying value	Weighted average life in years
Patents	$ 19,104	$ 18,226	$ 878	9.1
Developed technology	76,414	59,147	17,267	7.5
Trademarks and trade names	12,677	6,633	6,044	12.1
Customer relationships	56,700	33,761	22,939	11.1
Other	1,510	1,431	79	9.4
	$ 166,405	$ 119,198	$ 47,207	9.3

(In thousands)	2011 Gross carrying amount	Accumulated amortization	Net carrying value	Weighted average life in years
Patents	$ 19,035	$ 17,985	$ 1,050	9.1
Developed technology	76,639	56,524	20,115	7.5
Trademarks and trade names	12,561	5,579	6,982	12.1
Customer relationships	56,630	28,450	28,180	11.1
Other	1,604	1,478	126	9.0
	$ 166,469	$ 110,016	$ 56,453	9.3

The table below sets forth the amortization expense for the years ended December 31, 2012, 2011, and 2010:

(In thousands)	2012	2011	2010
Amortization expense	$ 9,594	$ 10,225	$ 13,231

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The amortization expense for each of the five succeeding years and thereafter relating to intangible assets currently recorded in the consolidated balance sheets is estimated to be the following at December 31, 2012:

Fiscal year ending December 31	*(In millions)*
2013	$ 9.0
2014	8.0
2015	5.8
2016	5.8
2017	5.8
Thereafter	12.8
	$ 47.2

(9) FINANCING ARRANGEMENTS

On June 9, 2011, the Company entered into a Credit Agreement (Agreement) with Wells Fargo Bank, National Association, as administrative agent, and certain other banks parties thereto.

The Agreement provides for a $30.0 million revolving credit facility maturing June 9, 2014. The financial covenants in the Agreement require that the Company maintain a cash flow leverage ratio of at least 3.0 to 1.0, measured by comparing quarterly total funded debt to EBITDA. In addition, the Company and its subsidiaries must maintain minimum cash and cash equivalents and certain other approved investments of at least $25.0 million, with $10.0 million held by the Borrowers with the Agent or its affiliates in bank accounts in the United States. Cash and cash equivalents and investments held by foreign subsidiaries are valued at 65% of the applicable currency value for purposes of these calculations. In addition to the financial metric covenants required under the revolving credit facility, under the terms of the Agreement, as amended in August 2012, the Company is restricted from making annual capital expenditures during any fiscal year in excess of $85.0 million. At both December 31, 2012 and 2011, the Company had no outstanding borrowings and was in compliance with all applicable debt covenants included in the terms of the Agreement.

Under the terms of the Agreement, the Company may elect that the loans comprising each borrowing bear interest at a rate per annum equal to either (a) the sum of 2.50%, plus the one month LIBOR rate then in effect, for base rate loans (Base Rate Loans); or (b) the sum of 2.50% plus, (i) the one-month LIBOR rate then in effect, (ii) the two-month LIBOR rate then in effect or (iii) the three-month LIBOR rate then in effect, for LIBOR loans (LIBOR Loans). The interest rate on Base Rate Loans will remain the same while such loan is outstanding, while the interest rate for LIBOR Loans will only be effective for the interest period which corresponds to the effective LIBOR rate. LIBOR Loans will convert to Base Rate Loans at the end of an applicable interest period unless the Company requests a new LIBOR Loan. Base Rate Loans may be converted to LIBOR Loans at the Company s option with three days notice to the Agent. In addition, the Company pays a commitment fee of 0.375% on the unborrowed commitments under the Agreement.

The Company has entered into unsecured line of credit agreements, which expire at various dates, with two international commercial banks, which provide for borrowings of Japanese yen for its foreign subsidiaries, equivalent to $14.0 million as of December 31, 2012. Interest rates for these facilities are based on a factor of the banks reference rates. Borrowings outstanding under international line of credit agreements were none at both December 31, 2012 and 2011.

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(10) LEASE COMMITMENTS

As of December 31, 2012, the Company was obligated under noncancellable operating lease agreements for certain sales offices and manufacturing facilities, manufacturing equipment, vehicles, information technology equipment and warehouse space. Future minimum lease payments for noncancellable operating leases with initial or remaining terms in excess of one year are as follows:

Fiscal year ending December 31	*(In thousands)*
2013	$ 8,288
2014	4,361
2015	4,073
2016	3,221
2017	2,566
Thereafter	3,304
Total minimum lease payments	$ 25,813

Total rental expense for all equipment and building operating leases for the years ended December 31, 2012, 2011, and 2010, were $9.4 million, $9.4 million, and $10.9 million, respectively.

(11) INCOME TAXES

Income before income taxes for the years ended December 31, 2012, 2011 and 2010 was derived from the following sources:

(In thousands)	2012	2011	2010
Domestic	$ 49,056	$ 68,839	$ 50,644
Foreign	50,647	59,125	50,837
Income before income taxes	$ 99,703	$ 127,964	$ 101,481

Income tax (benefit) expense for the years ended December 31, 2012, 2011, and 2010 is summarized as follows:

(In thousands)	2012	2011	2010
Current:			
Federal	$ 5,797	$ 2,382	$ 2,587
State	654	1,335	662
Foreign	11,183	17,784	15,292
	17,634	21,501	18,541
Deferred (net of valuation allowance):			
Federal	11,165	(19,853)	
State	168	(647)	
Foreign	1,914	3,216	(3,535)
	13,247	(17,284)	(3,535)
Income tax expense	$ 30,881	$ 4,217	$ 15,006

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Income tax expense differs from the expected amounts based upon the statutory federal tax rates for the years ended December 31, 2012, 2011, and 2010 as follows:

(In thousands)	2012	2011	2010
Expected federal income tax at statutory rate	$ 34,896	$ 44,788	$ 35,519
State income taxes before valuation allowance, net of federal tax effect	440	1,013	605
Income (losses) without tax expense (benefit)	(40)	(1,357)	215
Effect of foreign source income	(5,314)	1,959	(6,891)
Valuation allowance	358	(41,038)	(13,600)
Other items, net	541	(1,148)	(842)
Income tax expense	$ 30,881	$ 4,217	$ 15,006

As a result of commitments made by the Company related to investments in tangible property and equipment, the establishment of a research and development center in 2006 and certain employment commitments, income from certain manufacturing activities in Malaysia is exempt from tax for years up through 2015. The income tax benefits attributable to the tax status of this subsidiary are estimated to be $2.4 million (two cents per diluted share), none, and $6.5 million (5 cents per diluted share) for the years ended December 31, 2012, 2011, and 2010, respectively.

The significant components of the Company s deferred tax assets and deferred tax liabilities at December 31, 2012 and 2011 are as follows:

(In thousands)	2012	2011
Deferred tax assets attributable to:		
Accounts receivable	$ 389	$ 300
Inventory	2,643	2,789
Accruals not currently deductible for tax purposes	10,054	10,831
Net operating loss and credit carryforwards	2,669	11,403
Capital loss carryforward	3,105	3,105
Depreciation	2,870	4,553
Equity compensation	3,155	2,280
Asset impairments	1,021	1,021
Purchased intangibles	1,396	339
Other, net	3,604	3,090
Gross deferred tax assets	30,906	39,711
Valuation allowance	(4,990)	(4,632)
Total deferred tax assets	25,916	35,079
Deferred tax liabilities attributable to:		
Depreciation	(1,252)	(918)
Purchased intangible assets	(692)	(674)
Total deferred tax liabilities	(1,944)	(1,592)
Net deferred tax assets	$ 23,972	$ 33,487

Deferred tax assets are generally required to be reduced by a valuation allowance if, based on the weight of available positive and negative evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

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As of December 31, 2012 and 2011, the Company had a net U.S. deferred tax asset position of $18.7 million and $26.2 million, respectively, which are composed of temporary differences and various tax credit carryforwards. Management believes that it is more likely than not that the benefit from certain state net operating loss carryforwards, state credits, and a federal capital loss carryforward will not be realized. In recognition of this risk, management has provided a valuation allowance of $4.4 million and $4.3 million as of December 31, 2012 and 2011, respectively, on the related deferred tax assets. If the assumptions change and management determines the assets will be realized, the tax benefits relating to any reversal of the valuation allowance on deferred tax assets at December 31, 2012 will be recognized as a reduction of income tax expense. The increase in the amount of certain state credits in fiscal 2012 that will not be realized increased the valuation allowance resulting in tax expense of $0.1 million. Management estimates taxable income of $45.9 million will be necessary to utilize the remaining U.S. deferred tax assets as of December 31, 2012.

As of December 31, 2012 and 2011, the Company had a net non-U.S. deferred tax asset position of $10.2 million and $11.9 million, respectively, for which management determined based upon the available evidence a valuation allowance of $0.6 million and $0.3 million as of December 31, 2012 and 2011, respectively, were required against the non-U.S. deferred tax assets. For other non-U.S. jurisdictions, management is relying upon projections of future taxable income to utilize deferred tax assets. Estimated taxable income of $34.2 million will be necessary to utilize the non-U.S. deferred tax assets, of which an estimated $17.0 million is related to Nihon Entegris KK, the Company s Japanese subsidiary.

At December 31, 2012, there were approximately $299.6 million of accumulated undistributed earnings of subsidiaries outside the United States all of which are considered to be reinvested indefinitely. Management has considered its future cash needs and affirms its intention to indefinitely invest such earnings overseas to be utilized for working capital purposes, expansion of existing operations, possible acquisitions and other international items. No U.S. tax has been provided on such earnings. If they were remitted to the Company, applicable U.S. federal and foreign withholding taxes may be partially offset by available foreign tax credits. Management has concluded that it is impracticable to compute the full actual tax impact, but it estimates that $4.6 million of withholding taxes would be incurred if the $299.6 million were distributed.

At December 31, 2012, the Company had state operating loss carryforwards of approximately $2.0 million, which begin to expire in 2013; foreign tax credit carryforwards of approximately $5.7 million, which begin to expire in 2019; and foreign operating loss carryforwards of $5.1 million, which begin to expire in 2015.

Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax positions will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that fail to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. The provisions also provide guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties.

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Reconciliations of the beginning and ending balances of the total amounts of gross unrecognized tax benefits for the years ended December 31, 2012 and 2011 are as follows:

(In thousands)	2012	2011
Gross unrecognized tax benefits at beginning of year	$ 2,467	$ 2,527
Increases in tax positions for prior years		11
Decreases in tax positions for prior years	(19)	
Increases in tax positions for current year	4,608	992
Settlements	(1,044)	(291)
Lapse in statute of limitations	(593)	(772)
Gross unrecognized tax benefits at end of year	$ 5,419	$ 2,467

The total amount of net unrecognized tax benefits that, if recognized, would affect the effective tax rate was $0.7 million at December 31, 2012.

The Company s policy for recording interest and penalties associated with tax audits is to record such items as a component of income before taxes.

Penalties are recorded in other expense or income, and interest paid or received is recorded in interest expense or interest income, respectively, in the consolidated statements of operations. For the years ended December 31, 2012 and 2011, the Company has accrued interest and penalties related to unrecognized tax benefits of $1.0 million and $1.0 million, respectively. Interest and penalties of $(0.0) million, $(0.0) million and $(0.6) million were recognized in the consolidated statements of operations for the years ended December 31, 2012, 2011 and 2010, respectively.

The Company files income tax returns in the U.S. and in various state, local and foreign jurisdictions. The statute of limitations related to the consolidated Federal income tax return is closed for all years up to and including 2008. With respect to foreign jurisdictions, the statute of limitations varies from country to country, with the earliest open year for the Company s major foreign subsidiaries being 2007.

Due to the potential for resolution of a foreign examination and the expiration of various statutes of limitations, it is reasonably possible that the Company s gross unrecognized tax benefit balance may decrease within the next twelve months by approximately $1.9 million.

On January 2, 2013 President Obama signed into law H.R. 8, the American Taxpayer Relief Act of 2012. The Act reinstated the federal credit for increasing research expenditures retroactively to the beginning of 2012. Management estimates that during the first quarter of 2013, the Company will recognize a discrete tax benefit of approximately $1.1 million related to the credit. While other provisions of the Act may impact the filing of the 2012 federal income tax return, none of the other Act provisions are expected to have a material impact on the financial statements.

(12) EQUITY

Share Repurchase Program

On October 26, 2011, the Company announced that its Board of Directors had authorized the repurchase of up to an aggregate of $50 million of the Company s common stock in open market transactions and in accordance with a pre-arranged stock trading plan established on November 22, 2011 for the purpose of repurchasing up to $50 million of the registrant s common stock in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended (the Plan). The Plan commenced on November 28, 2011 and the expiration date of the Plan was extended until February 8, 2013.

On December 12, 2012, the Board of Directors authorized a repurchase program for 2013 covering up to an aggregate of $50 million of the Company s common stock in open market transactions and in accordance with

one or more pre-arranged stock trading plans established in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended.

Share-based Compensation Expense

The Company recognizes compensation expense for all share-based payment awards made to employees and directors based on their estimated fair values on the date of grant. Share-based compensation expense is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Share-based compensation expense for the years ended December 31, 2012, 2011 and 2010 is reflected in the table below:

(In thousands)	2012	2011	2010
Share-based compensation expense	$ 9,881	$ 7,519	$ 7,588

Employee Stock Plan

At December 31, 2009, the Company had outstanding stock awards under five stock incentive plans: the Entegris, Inc. 1999 Long-Term Incentive and Stock Option Plan; the Entegris, Inc. Outside Directors Option Plan and three former Mykrolis stock option plans assumed by the Company on August 10, 2005; the 2001 Equity Incentive Plan; the 2003 Employment Inducement and Acquisition Stock Option Plan; and the 2001 Non-Employee Director Stock Option Plan. On December 17, 2009, the Company s Board of Directors approved the 2010 Stock Plan, subject to the approval of the Company s stockholders. On May 5, 2010, the stockholders approved the 2010 Stock Plan. The 2010 Stock Plan replaced the above existing plans for future stock awards and stock option grants. Subsequent to the replacement of the prior plans on May 5, 2010, no awards were or will be made under the prior plans.

The 2010 Stock Plan provides for the issuance of stock options and other share-based awards to selected employees, directors, and other individuals or entities that provide services to the Company or its affiliates. The 2010 Stock Plan has a term of ten years. Under the 2010 Stock Plan, the Board of Directors or a committee selected by the Board of Directors will determine for each award, the term, price, number of shares, rate at which each award is exercisable and whether restrictions are imposed on the shares subject to the awards. The exercise price for option awards generally may not be less than the fair market value per share of the underlying common stock on the date granted. The 2010 Stock Plan allows that after December 31, 2009 any stock awards that were awarded from the expired plans mentioned above that are forfeited, expired or otherwise terminate without issuance of such stock award again be available for issuance under the 2010 Stock Plan.

General Option Information

Option activity for the 2010 Stock Plan and predecessor plans for the years ended December 31, 2012, 2011 and 2010 is summarized as follows:

	2012		2011		2010	
(Shares in thousands)	Number of shares	Weighted average exercise price	Number of shares	Weighted average exercise price	Number of shares	Weighted average exercise price
Options outstanding, beginning of year	3,561	$ 6.53	5,001	$ 6.25	6,663	$ 6.80
Granted	470	9.27	511	8.75	746	5.42
Exercised	(1,293)	3.76	(1,698)	5.95	(1,190)	4.68
Canceled	(173)	9.83	(253)	9.41	(1,218)	10.31
Options outstanding, end of year	2,565	$ 8.20	3,561	$ 6.53	5,001	$ 6.25
Options exercisable, end of year	1,828	$ 8.18	2,078	$ 7.53	3,013	$ 8.15

Options outstanding for the Company s stock plans at December 31, 2012 are summarized as follows:

(Shares in thousands)	Options outstanding			Options exercisable	
Range of exercise prices	Number outstanding	Weighted average remaining life in years	Weighted-average exercise price	Number exercisable	Weighted average exercise price
$1.13 to $3.08	183	3.1 years	$ 1.26	183	$ 1.26
$4.61 to $7.68	692	2.6 years	6.30	529	6.57
$7.69 to $9.22	767	3.0 years	8.63	504	8.56
$9.23 to $15.38	923	2.5 years	10.64	612	11.33
	2,565	2.7 years		1,828	

The weighted average remaining contractual term for options outstanding and exercisable for all plans at December 31, 2012 was 2.7 years and 1.7 years, respectively.

For all plans, the Company had shares available for future grants of 7.7 million shares, 8.6 million shares, and 9.5 million shares at December 31, 2012, 2011 and 2010, respectively.

For all plans, the total pre-tax intrinsic value of stock options exercised during the years ended December 31, 2012 and 2011 was $6.7 million and $5.0 million, respectively. The aggregate intrinsic value, which represents the total pre-tax intrinsic value based on the Company s closing stock price of $9.18 at December 31, 2012, which theoretically could have been received by the option holders had all option holders exercised their options as of that date, was $3.9 million and $3.1 million for options outstanding and options exercisable, respectively.

Employee Stock Purchase Plan

The Company maintains the Entegris, Inc. Employee Stock Purchase Plan (ESPP). A total of 4.0 million common shares are reserved for issuance under the ESPP. The ESPP allows employees to elect, at six-month intervals, to contribute up to 10% of their compensation, subject to certain limitations, to purchase shares of common stock at a discount of 15% from the fair market value on the first day or last day of each six-month period. The Company treats the ESPP as a compensatory plan. As of December 31, 2012, 3.3 million shares had been issued under the ESPP. At December 31, 2012, 0.7 million shares remained available for issuance under the ESPP. Employees purchased 0.3 million shares, 0.4 million shares, and 0.4 million shares, at a weighted-average price of $7.34, $4.35, and $2.88 during the years ended December 31, 2012, 2011 and 2010, respectively.

The table below sets forth the amount of cash received by the Company from the exercise of stock options and employee contributions to the ESPP during the years ended December 31, 2012, 2011 and 2010:

(In thousands)	2012	2011	2010
Exercise of stock options and employee contributions to the ESPP	$ 7,431	$ 11,690	$ 6,799

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Restricted Stock Awards

Restricted stock awards are awards of common stock made under the 2010 Stock Plan and predecessor plans that are subject to restrictions on transfer and to a risk of forfeiture if the awardee terminates employment with the Company prior to the lapse of the restrictions. The value of such stock is determined using the market price on the grant date. Compensation expense for restricted stock awards is generally recognized using the straight-line single-option method. A summary of the Company s restricted stock activity for the years ended December 31, 2012, 2011 and 2010 is presented in the following table:

(Shares in thousands)	2012		2011		2010	
	Number of shares	Weighted average grant date fair value	Number of shares	Weighted average grant date fair value	Number of shares	Weighted average grant date fair value
Unvested, beginning of year	2,298	$ 5.49	2,738	$ 4.43	3,263	$ 3.74
Granted	744	9.21	795	8.65	1,205	5.75
Vested	(1,132)	5.42	(1,087)	5.22	(1,640)	4.04
Forfeited	(108)	6.22	(148)	4.89	(90)	4.11
Unvested, end of year	1,802	$ 7.02	2,298	$ 5.49	2,738	$ 4.43

The weighted average remaining contractual term for unvested restricted shares at December 31, 2012 and 2011 was 1.8 years and 2.0 years, respectively.

As of December 31, 2012, the total compensation cost related to unvested stock options and restricted stock awards not yet recognized was $2.4 million and $8.9 million, respectively, and is expected to be recognized over the next 2.5 years on a weighted-average basis.

Valuation and Expense Information

The following table summarizes the allocation of share-based compensation expense related to employee stock options, restricted stock awards and grants under the employee stock purchase plan accounted for under ASC 718 for the years ended December 31, 2012, 2011 and 2010:

(In thousands)	2012	2011	2010
Cost of sales	$ 575	$ 650	$ 604
Engineering, research and development expenses	500	566	476
Selling, general and administrative expenses	8,806	6,303	6,523
Share-based compensation expense	9,881	7,519	7,603
Tax benefit	3,686	2,805	2,836
Share-based compensation expense, net of tax	$ 6,195	$ 4,714	$ 4,767

Stock Options

Share-based payment awards in the form of stock option awards for 0.5 million, 0.5 million and 0.7 million options were granted to employees during the years ended December 31, 2012, 2011, and 2010. Compensation expense is based on the grant date fair value. The awards vest annually over a three-year or four-year period and have a contractual term of seven years. The Company estimates the fair value of stock options using the Black-Scholes valuation model. Key inputs and assumptions used to estimate the fair value of stock options include the grant price of the award, the expected option term, volatility of the Company s stock, the risk-free rate and the Company s dividend yield. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by employees who receive equity awards, and subsequent events are not indicative of reasonableness of the original estimates of fair value made by the Company.

The fair value of each stock option grant was estimated at the date of grant using a Black-Scholes option pricing model. The following table presents the weighted-average assumptions used in the valuation and the resulting weighted-average fair value per option granted for the years ended December 31, 2012, 2011 and 2010:

Employee stock options:	2012	2011	2010
Volatility	82.4%	79.3%	75.2%
Risk-free interest rate	0.6%	1.8%	2.1%
Dividend yield	0%	0%	0%
Expected life	3.8 years	4 years	3.9 years
Weighted average fair value per option	$ 5.42	$ 5.14	$ 3.25

A historical daily measurement of volatility is determined based on the expected life of the option granted. The risk-free interest rate is determined by reference to the yield on an outstanding U.S. Treasury note with a term equal to the expected life of the option granted. Expected life is determined by reference to the Company s historical experience. The Company determines the dividend yield by dividing the expected annual dividend on the Company s stock by the option exercise price.

Shareholder Rights Plan On July 27, 2005, the Company s Board of Directors adopted a shareholder rights plan (the Rights Plan) pursuant to which Entegris declared a dividend on August 8, 2005 to its shareholders of record on that date of one preferred share purchase right (a Right) for each share of Entegris common stock owned on August 8, 2005 and authorized the issuance of Rights in connection with future issuances of Entegris common stock. Each Right entitles the holder to purchase one-hundredth of a share of a series of preferred stock at an exercise price of $50, subject to adjustment as provided in the Rights Plan. The Rights Plan is designed to protect Entegris shareholders from attempts by others to acquire Entegris on terms or by using tactics that could deny all shareholders the opportunity to realize the full value of their investment. The Rights are attached to the shares of the Company s common stock until certain triggering events specified in the Rights Agreement occur, including, unless approved by the Company s Board of Directors, an acquisition by a person or group of specified levels of beneficial ownership of Entegris common stock or a tender offer for Entegris common stock. Upon the occurrence of any of these triggering events, the Rights authorize the holders to purchase at the then-current exercise price for the Rights, that number of shares of the Company s common stock having a value equal to twice the exercise price. The Rights are redeemable by the Company for $0.01 and will expire on August 8, 2015. One of the events which will trigger the Rights is the acquisition, or commencement of a tender offer, by a person (an Acquiring Person, as defined in the shareholder rights plan), other than Entegris or any of its subsidiaries or employee benefit plans, of 15% or more of the outstanding shares of the Company s common stock. An Acquiring Person may not exercise a Right.

(13) BENEFIT PLANS

401(k) Plan The Company maintains the Entegris, Inc. 401(k) Savings and Profit Sharing Plan (the 401(k) Plan) that qualifies as a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. Under the Plan, eligible employees may defer a portion of their pre-tax wages, up to the Internal Revenue Service annual contribution limit. Entegris matches employees contributions to a maximum match of 4% of the employee s eligible wages. The employer matching contribution expense under the Plan was $3.0 million, $3.2 million and $2.5 million in the fiscal years ended December 31, 2012, 2011 and 2010, respectively.

Defined Benefit Plans The employees of the Company s subsidiaries in Japan, Taiwan and Germany are covered in defined benefit pension plans. The Company uses a December 31 measurement date for its pension plans.

In the third quarter of 2011, the Company s Japan defined benefit pension plan (the Plan) was amended. Under the amendment, employees will no longer accrue benefits under the Plan and instead will participate in a defined contribution arrangement from the date on which their benefits under the Plan were frozen. The Company

remeasured the projected benefit obligation and plan assets of the amended plan, which resulted in a $4.675 million reduction in the Company s pension liability. In addition, the Plan s assets of $5.7 million were used to settle a portion of the defined benefit pension liability associated with the plan. The Company s remaining pension liability associated with the Plan is $13.9 million as of December 31, 2011. The Company recognized a curtailment gain of $726 thousand million in connection with this amendment in the third quarter of 2011 that is classified within Selling, general, and administrative expenses in the Company s consolidated statements of operations.

The tables below set forth the Company s estimated funded status as of December 31, 2012 and 2011:

(In thousands)	2012	2011
Change in benefit obligation:		
Benefit obligation at beginning of period	$ 16,364	$ 26,515
Acquisitions		16
Service cost	89	1,268
Interest cost	163	290
Actuarial losses (gain)	367	(27)
Benefits paid	(3,329)	(2,596)
Curtailments		(4,675)
Settlements		(5,710)
Foreign exchange impact	(1,047)	1,283
Benefit obligation at end of period	12,607	16,364
Change in plan assets:		
Fair value of plan assets at beginning of period	357	6,040
Return on plan assets	4	(36)
Employer contributions	8	866
Benefits paid		(1,133)
Settlements		(5,511)
Foreign exchange impact	13	131
Fair value of plan assets at end of period	382	357
Funded status:		
Plan assets less than benefit obligation - Net amount recognized	$ (12,225)	$ (16,007)

Amounts recognized in the consolidated balance sheet consist of:

(In thousands)	2012	2011
Noncurrent liability	$ (12,225)	$ (16,007)
Accumulated other comprehensive loss, net of taxes	1,058	764

Amounts recognized in accumulated other comprehensive loss, net of tax consist of:

(In thousands)	2012	2011
Net actuarial loss	$ 1,028	$ 648
Prior service cost	287	295
Unrecognized transition obligation	(12)	(13)
Gross amount recognized	1,303	930
Deferred income taxes	(245)	(166)

Net amount recognized	$ 1,058	$ 764

Information for pension plans with an accumulated benefit obligation in excess of plan assets:

(In thousands)	2012	2011
Projected benefit obligation	$ 12,607	$ 16,364
Accumulated benefit obligation	11,293	15,280
Fair value of plan assets	382	357

The components of the net periodic benefit cost for the years ended December 31, 2012, 2011 and 2010 are as follows:

(In thousands)	2012	2011	2010
Pension benefits:			
Service cost	$ 89	$ 1,268	$ 1,654
Interest cost	163	290	319
Expected return on plan assets	(7)	(65)	(76)
Amortization of prior service cost	19	126	163
Amortization of net transition obligation	(1)	(1)	(1)
Amortization of plan loss	20	49	247
Recognized actuarial net loss	1	1	
Acquisition		16	
Curtailments		(726)	
Net periodic pension benefit cost	$ 284	$ 958	$ 2,306

The estimated amount that will be amortized from accumulated other comprehensive income into net periodic benefit cost in 2013 is as follows:

(In thousands)	
Transition obligation	$ (1)
Prior service cost	19
Net actuarial loss	40
	$ 58

Assumptions used in determining the benefit obligation and net periodic benefit cost for the Company s pension plans for the years ended December 31, 2012, 2011 and 2010 are presented in the following table as weighted-averages:

	2012	2011	2010
Benefit obligations:			
Discount rate	1.19%	1.40%	1.29%
Rate of compensation increase	4.18%	4.22%	5.23%
Net periodic benefit cost:			
Discount rate	1.80%	1.38%	1.36%
Rate of compensation increase	2.84%	5.14%	5.26%
Expected return on plan assets	1.14%	1.52%	1.53%

The plans expected return on assets as shown above is based on management s expectations of long-term average rates of return to be achieved by the underlying investment portfolios. In establishing this assumption, management considers historical and expected returns for the asset classes in which the plans are invested, as well as current economic and capital market conditions. The discount rate primarily used by the Company is based on market yields at the valuation date on government bonds as well as the estimated maturity of benefit payments.

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Plan Assets

At December 31, 2012 and 2011, the Company s pension plan assets are deposited in Bank of Taiwan in the form of money market funds, where Bank of Taiwan is the assigned funding vehicle for the statutory retirement benefit.

The fair value measurements of the Company s pension plan assets at December 31, 2012, by asset category are as follows:

(In thousands) Asset category	Total	Quoted prices in active markets for identical assets (Level 1)	Significant observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Taiwan plan assets (a)	$ 382	$ 382		
	$ 382	$ 382		

(a) This category includes investments in the government of Taiwan s pension fund. The government of Taiwan is responsible for the strategy and allocation of the investment contributions.

The fair value measurements of the Company s pension plan assets at December 31, 2011, by asset category are as follows:

(In thousands) Asset category	Total	Quoted prices in active markets for identical assets (Level 1)	Significant observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Taiwan plan assets (a)	$ 357	$ 357		
	$ 357	$ 357		

(a) This category includes investments in the government of Taiwan s pension fund. The government of Taiwan is responsible for the strategy and allocation of the investment contributions.

Cash Flows

The Company expects to make the following contributions and benefit payments:

(In thousands)	Contributions	Payments

2013	$ 629	$ 25
2014		285
2015		320
2016		219
2017		311
Years 2018-2022		2,187

(14) FAIR VALUE MEASUREMENTS

Generally accepted accounting principles establish a fair value hierarchy that prioritizes the inputs used to measure fair value. The three levels of the fair value hierarchy are as follows:

Level 1 Quoted prices in active markets accessible at the reporting date for identical assets and liabilities.

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Level 2 Quoted prices for similar assets or liabilities in active markets. Quoted prices for identical or similar assets and liabilities in markets that are not considered active or financial instruments for which all significant inputs are observable, either directly or indirectly.

Level 3 Prices or valuations that require inputs that are significant to the valuation and are unobservable.

A financial instrument s level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

Financial Assets Measured at Fair Value on a Recurring Basis

The following table presents the Company s financial assets and liabilities that are measured at fair value on a recurring basis at December 31, 2012 and 2011.

	December 31, 2012				December 31, 2011			
(In thousands)	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets:								
Cash equivalents								
Commercial paper	$	$ 59,980	$	$ 59,980	$	$ 14,605	$	$ 14,605
Money market fund deposits	73,026			73,026	83,320			83,320
Short-term investments								
Commercial paper		19,995		19,995				
Total assets measured and recorded at fair value	$ 73,026	$ 79,995	$	$ 153,001	$ 83,320	$ 14,605	$	$ 97,925
Liabilities:								
Derivative financial instruments								
Foreign exchange forward contracts	$	$ 4,603	$	$ 4,603	$	$ 491	$	$ 491
Total liabilities measured and recorded at fair value	$	$ 4,603	$	$ 4,603	$	$ 491	$	$ 491

Items Measured at Fair Value on a Nonrecurring Basis

On April 2, 2012, the Company acquired the remaining 50% of Entegris Precision Technologies Corporation (EPT) in Taiwan, an entity in which it had previously owned a 50% equity interest accounted for under the equity method. The transaction was accounted for under the acquisition method of accounting and the results of operations of the entity are included in the Company s consolidated financial statements as of and since April 2, 2012. The investee s sales and operating results are not material to the Company s consolidated financial statements. The Company paid $3.4 million in cash for the additional 50% equity interest in the entity.

The Company remeasured its previously held equity interest in the entity at its April 2, 2012 fair value of $2.9 million. Based on the carrying value of the Company s equity interest in EPT before the business combination, the Company recognized a gain of $1.3 million. In prior reporting periods, the Company recognized changes in the value of its equity interest in EPT related to translation adjustments in other comprehensive income. Accordingly, the $216 thousand recognized previously in other comprehensive income was reclassified and included in the calculation of the gain.

The purchase price has been allocated based on the fair values of all of the assets acquired and liabilities assumed. The valuation of the assets acquired and liabilities assumed, as well as the Company s previously held equity interest, was based on the information that was available as of the acquisition date and the expectations and assumptions that have been deemed reasonable by the Company s management.

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In performing these valuations, the Company used independent appraisals and discounted cash flows and other factors as the best evidence of fair value. The key underlying assumptions of the discounted cash flows were projected revenues, gross margin expectations and operating cost estimates. There are inherent uncertainties and management judgment required in these determinations. No assurance can be given that the underlying assumptions will occur as projected. The fair value measurements of the assets acquired and liabilities assumed were based on valuations involving significant unobservable inputs, or Level 3 in the fair value hierarchy.

The sum of the purchase price of the additional 50% equity interest and the fair value of the equity interest in the investee held by the Company at the acquisition date exceeded the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed by $2.2 million.

In the second quarter of 2011, the Company recorded a gain of $1.5 million on the sale of an equity investment that was classified within other (income) expense, net in the consolidated statements of operations. The gain comprised two components a $0.2 million loss related to the disposition of the equity interest and a $1.715 million gain related to the cumulative translation reclassification adjustment associated with the equity method investee. The carrying value of the investment at the time of the sale was $4.1 million. The Company received assets recorded at fair value of $3.9 million ($1.8 million of cash, $0.4 million of equipment, and $1.712 million of intangible assets) resulting in the aforementioned loss. The fair value measurement of the intangible assets received was based on valuations involving significant unobservable inputs, generally utilizing the market approach, or Level 3 in the fair value hierarchy.

In 2010, the Company recorded an other-than-temporary impairment of $2.2 million related to an equity investment. The fair value of the investment after impairment was $4.1 million at December 31, 2010 and is classified as a Level 3 investment in the fair value hierarchy. The fair value measurement of the equity investment was based on a valuation involving significant unobservable inputs, generally utilizing the market approach.

The fair value measurements of the assets acquired and liabilities assumed in the acquisition of Pureline as described in Note 2 to the consolidated financial statements were generally based on valuations involving significant unobservable inputs, or Level 3 in the fair value hierarchy.

(15) EARNINGS PER SHARE (EPS)

Basic EPS is computed by dividing net income attributable to Entegris, Inc. by the weighted average number of shares of common stock outstanding during each period. The following table presents a reconciliation of the share amounts used in the computation of basic and diluted earnings per share:

(In thousands)	2012	2011	2010
Basic earnings per share Weighted common shares outstanding	137,306	134,685	131,685
Weighted common shares assumed upon exercise of options and vesting of restricted stock units	1,106	1,538	1,489
Diluted earnings per share Weighted common shares outstanding	138,412	136,223	133,174

We excluded the following shares underlying stock-based awards from the calculations of diluted EPS because their inclusion would have been anti-dilutive for the years ended December 31, 2012, 2011 and 2010:

(In thousands)	2012	2011	2010
Shares excluded from calculations of diluted EPS	1,431	1,471	3,753

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(16) SEGMENT INFORMATION

The Company s financial reporting segments are: Contamination Control Solutions (CCS), Microenvironments (ME), and Specialty Materials (SMD).

CCS: provides a wide range of products and subsystems that purify, monitor and deliver critical liquids and gases used in the semiconductor manufacturing process.

ME: provides products that protect wafers, reticles and electronic components at various stages of transport, processing and storage.

SMD: provides specialized graphite components used in semiconductor equipment and offers low-temperature, plasma-enhanced chemical vapor deposition coatings of critical components of semiconductor manufacturing equipment used in various stages of the manufacturing process.

Intersegment sales are not significant. Corporate assets consist primarily of cash and cash equivalents, short-term investments, assets held for sale, investments, deferred tax assets and deferred tax charges.

Segment profit is defined as net sales less direct segment operating expenses, excluding certain unallocated expenses, consisting mainly of general and administrative costs for the Company s human resources, finance and information technology functions, as well as amortization of intangible assets, charges for the fair market value write-up of acquired inventory sold and restructuring charges before interest expense, income taxes and equity in earnings of affiliates.

Summarized financial information for the Company s reportable segments is shown in the following table:

(In thousands)	2012	2011	2010
Net sales:			
CCS	$ 461,838	$ 483,958	$ 435,858
ME	182,375	182,150	182,485
SMD	71,690	83,151	70,073
Total net sales	$ 715,903	$ 749,259	$ 688,416

(*In thousands*)	2012	2011	2010
Segment profit:			
CCS	$ 116,356	$ 140,313	$ 122,891
ME	37,223	29,959	38,930
SMD	12,230	18,255	11,080
Total segment profit	$ 165,809	$ 188,527	$ 172,901

(*In thousands*)	2012	2011	2010
Total assets:			
CCS	$ 234,766	$ 213,477	$ 222,015
ME	86,755	89,642	95,999
SMD	90,797	94,191	108,872
Corporate	399,226	327,353	174,499

Total assets	$ 811,544	$ 724,663	$ 601,385

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(In thousands)	2012	2011	2010
Depreciation and amortization:			
CCS	$ 15,725	$ 15,682	$ 18,632
ME	8,765	7,859	7,781
SMD	10,626	10,694	11,113
Corporate	2,491	2,829	3,672
Total depreciation and amortization	$ 37,607	$ 37,064	$ 41,198

(In thousands)	2012	2011	2010
Capital expenditures:			
CCS	$ 29,650	$ 16,170	$ 11,043
ME	12,632	8,618	2,175
SMD	3,980	3,039	1,368
Corporate	3,667	2,440	2,208
Total capital expenditures	$ 49,929	$ 30,267	$ 16,794

The following table reconciles total segment profit to operating income:

(In thousands)	2012	2011	2010
Total segment profit	$ 165,809	$ 188,527	$ 172,901
Less:			
Amortization of intangibles	9,594	10,225	13,231
Unallocated general and administrative expenses	56,771	51,424	53,243
Operating income	$ 99,444	$ 126,878	$ 106,427
Interest expense	271	886	3,598
Interest income	(281)	(227)	(82)
Other (income) expense, net	(249)	(1,745)	1,430
Income before income taxes and equity in net income of affiliates	$ 99,703	$ 127,964	$ 101,481

The following table presents amortization of intangibles for each of the Company s segments for the years ended December 31, 2012, 2011 and 2010:

(In thousands)	2012	2011	2010
Amortization of intangibles:			
CCS	$ 4,230	$ 4,588	$ 7,553
ME	139	406	416
SMD	5,225	5,231	5,262
	$ 9,594	$ 10,225	$ 13,231

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The following table summarizes total net sales, based upon the country to which sales to external customers were made for the years ended December 31, 2012, 2011 and 2010:

(In thousands)	2012	2011	2010
Net sales:			
United States	$ 218,903	$ 213,671	$ 193,408
Japan	131,521	140,657	125,372
Germany	24,437	33,020	27,879
Taiwan	126,732	116,007	109,667
Singapore	25,607	28,337	31,432
South Korea	70,763	76,888	64,514
China	31,499	40,080	44,855
Other	86,441	100,599	91,289
	$ 715,903	$ 749,259	$ 688,416

The following table summarizes property, plant and equipment, net, attributed to significant countries for the years ended December 31, 2012, 2011 and 2010:

(In thousands)	2012	2011	2010
Property, plant and equipment:			
United States	$ 86,476	$ 59,444	$ 60,337
Japan	27,024	29,295	28,986
Malaysia	28,398	30,328	26,349
Other	15,123	11,487	11,053
	$ 157,021	$ 130,554	$ 126,725

In the years ended December 31, 2012, 2011, and 2010, no single customer accounted for ten percent or more of net sales.

(17) COMMITMENTS AND CONTINGENT LIABILITIES

The Company is subject to various claims, legal actions, and complaints arising in the ordinary course of business. The Company believes the final outcome of these matters will not have a material adverse effect on its consolidated financial statements. The Company expenses legal costs as incurred.

(18) QUARTERLY INFORMATION-UNAUDITED

	Fiscal quarter ended			
(In thousands, except per share data)	March 31, 2012	June 30, 2012	September 29, 2012	December 31, 2012
Net sales	$ 175,403	$ 188,233	$ 184,449	$ 167,818
Gross profit	76,244	82,746	81,932	66,461
Net income	17,859	21,673	18,037	11,256
Basic income per share	0.13	0.16	0.13	0.08
Diluted income per share	0.13	0.16	0.13	0.08

Fiscal quarter ended

(In thousands, except per share data)	April 2, 2011	July 2, 2011	October 1, 2011	December 31, 2011
Net sales	$ 203,125	$ 209,198	$ 173,014	$ 163,922
Gross profit	88,345	95,143	74,828	67,614
Net income	29,175	32,522	21,988	40,161
Basic income per share	0.22	0.24	0.16	0.30
Diluted income per share	0.22	0.24	0.16	0.29