PROGRESSIVE CORP/OH/
Form 10-Q
November 02, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 1O-Q

(Mark One)

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2006

or

o **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: 1-9518

THE PROGRESSIVE CORPORATION

(Exact name of registrant as specified in its charter)

Ohio	34-0963169
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6300 Wilson Mills Road, Mayfield Village, Ohio	44143
(Address of principal executive offices)	(Zip Code)

(440) 461-5000

(Registrant s telephone number, including area code)

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

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 þ Accelerated filer o Non-accelerated filer o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common Shares, $1.00 par value 761,687,647 outstanding at September 30, 2006

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

The Progressive Corporation and Subsidiaries

Consolidated Statements of Income

(unaudited)

	Three Months			Nine Months		
Periods Ended September 30, (millions except per share amounts)	2006	2005	% Change	2006	2005	% Change
Revenues:						
Net premiums earned	$ 3,544.3	$ 3,478.9	2	$ 10,609.2	$ 10,282.7	3
Investment income	169.8	138.0	23	484.0	388.2	25
Net realized gains (losses) on securities	2.4	(4.1)	NM	(24.2)	2.3	NM
Service revenues	7.3	9.7	(25)	23.6	31.2	(24)
Total revenues	3,723.8	3,622.5	3	11,092.6	10,704.4	4
Expenses:						
Losses and loss adjustment expenses	2,367.7	2,467.8	(4)	7,034.7	6,901.0	2
Policy acquisition costs	359.7	364.7	(1)	1,086.7	1,087.0	
Other underwriting expenses	365.7	312.2	17	1,042.2	977.8	7
Investment expenses	2.9	2.9		8.8	8.8	
Service expenses	6.2	6.4	(3)	19.3	18.4	5
Interest expense	18.5	20.7	(11)	58.4	62.2	(6)
Total expenses	3,120.7	3,174.7	(2)	9,250.1	9,055.2	2
Income before income taxes	603.1	447.8	35	1,842.5	1,649.2	12
Provision for income taxes	193.5	142.5	36	595.9	536.9	11
Net income	$ 409.6	$ 305.3	34	$ 1,246.6	$ 1,112.3	12
COMPUTATION OF EARNINGS PER SHARE						
Basic:						
Average shares outstanding	763.2	783.1	(3)	779.7	789.1	(1)
Per share	$ .54	$ .39	38	$ 1.60	$ 1.41	13
Diluted:						
Average shares outstanding	763.2	783.1	(3)	779.7	789.1	(1)
Net effect of dilutive stock-based compensation	9.0	11.4	(21)	9.8	11.6	(16)

Total equivalent shares		772.2		794.5	(3)		789.5		800.7	(1)
Per share	$	.53	$	.38	38	$	1.58	$	1.39	14
Dividends per Share	$	.00875	$	.00750	17	$	.02375	$	.02250	6

NM = Not
Meaningful
All share and per share amounts were adjusted for the May 18, 2006, 4-for-1 stock split.
See notes to consolidated financial statements.

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The Progressive Corporation and Subsidiaries
Consolidated Balance Sheets
(unaudited)

(millions)	September, 30, 2006	September, 30, 2005	December 31, 2005
Assets			
Investments Available-for-sale, at market:			
Fixed maturities (amortized cost: $10,017.7, $10,420.3 and $10,260.7)	$ 10,044.3	$ 10,397.8	$ 10,221.9
Equity securities:			
Preferred stocks (cost: $1,523.0, $1,188.2 and $1,217.0)	1,535.4	1,192.8	1,220.3
Common equities (cost: $1,454.9, $1,413.0 and $1,423.4)	2,215.9	2,016.9	2,058.9
Short-term investments (amortized cost: $1,057.3, $918.9 and $773.5)	1,057.9	919.2	773.6
Total investments	14,853.5	14,526.7	14,274.7
Cash	14.5	6.9	5.6
Accrued investment income	155.5	119.0	133.1
Premiums receivable, net of allowance for doubtful accounts of $116.7, $105.2 and $116.3	2,698.6	2,627.7	2,500.7
Reinsurance recoverables, including $58.1, $52.0 and $58.5 on paid losses	387.0	391.4	405.7
Prepaid reinsurance premiums	98.1	114.6	103.7
Deferred acquisition costs	477.3	477.5	444.8
Income taxes	36.1	65.4	138.3
Property and equipment, net of accumulated depreciation of $585.5, $575.7 and $562.0	941.6	695.8	758.7
Other assets	184.0	130.1	133.3
Total assets	$ 19,846.2	$ 19,155.1	$ 18,898.6
Liabilities and Shareholders Equity			
Unearned premiums	$ 4,658.1	$ 4,575.9	$ 4,335.1
Loss and loss adjustment expense reserves	5,724.3	5,737.4	5,660.3
Accounts payable, accrued expenses and other liabilities	1,564.3	1,746.5	1,510.8
Debt[1]	1,185.4	1,284.8	1,284.9
Total liabilities	13,132.1	13,344.6	12,791.1
Shareholders equity:			
Common Shares, $1.00 par value (authorized 900.0, 600.0 and 600.0; issued 798.7, 213.1 and 213.1, including treasury shares of 37.0, 16.0 and 15.8)	761.7	197.1	197.3
Paid-in capital	837.2	830.6	848.2
Unamortized restricted stock[2]		(68.9)	(62.7)
Accumulated other comprehensive income:			

Net unrealized gains on securities	520.4	381.1	390.1
Net unrealized gains on forecasted transactions	7.8	8.9	8.6
Retained earnings	4,587.0	4,461.7	4,726.0
Total shareholders equity	6,714.1	5,810.5	6,107.5
Total liabilities and shareholders equity	$ 19,846.2	$ 19,155.1	$ 18,898.6

[1] Includes current and non-current debt. See *Note 4-Debt*.

[2] Reclassified pursuant to the adoption of SFAS 123 (R); See *Note 2 Stock-Based Compensation* for further discussion.

See notes to consolidated financial statements.

The Progressive Corporation and Subsidiaries
Consolidated Statements of Cash Flows
(unaudited)

Nine Months Ended September 30, (millions)	2006	2005
Cash Flows From Operating Activities		
Net income	$ 1,246.6	$ 1,112.3
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	76.0	68.5
Amortization of fixed maturities	162.9	140.3
Amortization of stock-based compensation	18.7	24.0
Net realized (gains) losses on securities	24.2	(2.3)
Gain on sale of property and equipment	(5.8)	
Changes in:		
Unearned premiums	323.0	467.9
Loss and loss adjustment expense reserves	64.0	451.8
Accounts payable, accrued expenses and other liabilities	136.5	137.7
Prepaid reinsurance premiums	5.6	5.2
Reinsurance recoverables	18.7	(9.8)
Premiums receivable	(197.9)	(340.5)
Deferred acquisition costs	(32.5)	(45.3)
Income taxes	32.0	(62.3)
Tax benefit from exercise/vesting of stock-based compensation[1]		31.9
Other, net	(68.8)	(54.5)
Net cash provided by operating activities	1,803.2	1,924.9
Cash Flows From Investing Activities		
Purchases:		
Fixed maturities	(5,203.6)	(6,546.5)
Equity securities	(720.4)	(770.2)
Short-term investments auction rate securities	(1,339.5)	(7,510.0)
Sales:		
Fixed maturities	4,707.3	4,591.4
Equity securities	221.5	35.2
Short-term investments auction rate securities	1,351.6	7,812.5
Maturities, paydowns, calls and other:		
Fixed maturities	546.3	402.9
Equity securities	165.9	158.7
Net (purchases) sales of short-term investments other	(294.5)	160.2
Net unsettled security transactions	(70.5)	277.1
Purchases of property and equipment	(267.3)	(132.4)
Sale of property and equipment	14.0	36.1
Net cash used in investing activities	(889.2)	(1,485.0)
Cash Flows From Financing Activities		
Proceeds from exercise of stock options	31.5	35.7
Tax benefit from exercise/vesting of stock-based compensation[1]	27.4	

Payment of debt	(100.0)	
Dividends paid to shareholders	(18.5)	(17.8)
Acquisition of treasury shares	(845.5)	(470.9)
Net cash used in financing activities	(905.1)	(453.0)
Increase (decrease) in cash	8.9	(13.1)
Cash, January 1	5.6	20.0
Cash, September 30	$ 14.5	$ 6.9

[1] Reclassified pursuant to the adoption of SFAS 123 (R).

See notes to consolidated financial statements.

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The Progressive Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited)

Note 1 *Basis of Presentation* These financial statements and the notes thereto should be read in conjunction with Progressive s audited financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2005.

The consolidated financial statements reflect all normal recurring adjustments which, in the opinion of management, were necessary for a fair statement of the results for the interim periods presented. The results of operations for the periods ended September 30, 2006, are not necessarily indicative of the results expected for the full year.

On April 21, 2006, the Board of Directors approved a 4-for-1 stock split that was paid in the form of a stock dividend on May 18, 2006. All applicable share and per share amounts were adjusted for the stock split.

Note 2 *Stock-Based Compensation* As of January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards 123 (revised 2004), Share-Based Payment (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors.

We adopted SFAS 123(R) using the modified prospective method as of January 1, 2006. As a result, our consolidated financial statements for the nine months ended September 30, 2006, reflect the effect of SFAS 123(R), including the reclassification of any unamortized restricted stock (i.e., unearned compensation) against paid-in capital for restricted stock awards accounted for as equity awards and against other liabilities for the restricted stock awards accounted for as liability awards (i.e., 2003 and 2004 restricted stock awards deferred pursuant to our deferred compensation plans). In accordance with the modified prospective transition method, our consolidated financial statements for prior periods have not been restated to reflect, and do not include, the effect of SFAS 123(R).

Pursuant to the modified prospective application, we are required to expense the fair value at the grant date of our unvested outstanding stock options. No stock options have been granted after December 31, 2002. We will not incur any additional expense relating to currently outstanding stock options in years subsequent to 2006, since the final vesting date of stock options previously granted will be January 1, 2007. Beginning in 2003, we began issuing restricted stock awards as our form of equity compensation to key members of management and non-employee directors in lieu of stock options; our current equity compensation program does not contemplate the issuance of stock options. Compensation expense for restricted stock awards is recognized over the respective vesting periods. The current year expense for restricted stock is not representative of the effect on net income for future years since each subsequent year will reflect expense for additional awards.

For the nine months ended September 30, 2006, the pre-tax expense of our stock-based compensation was $18.7 million (tax benefit of $6.5 million), of which $.9 million related to our unvested outstanding stock options. We used the modified Black-Scholes pricing model to calculate the fair value of the options awarded as of the date of grant.

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The following table shows the effect on net income and earnings per share had the fair value based method been applied to all outstanding and unvested stock option awards for the nine months ended September 30, 2005:

(millions, except per share amounts)		
Net income, as reported	$	1,112.3
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all stock option awards, net of related tax effects		(1.9)
Net income, pro forma	$	1,110.4
Earnings per share		
Basic as reported	$	1.41
Basic pro forma		1.41
Diluted as reported	$	1.39
Diluted pro forma		1.39

In addition, in conjunction with the Financial Accounting Standards Board Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards, we elected to adopt the alternative transition method for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool related to the tax effects of employee stock-based compensation, and to determine the subsequent effect on the paid-in capital pool and the consolidated statements of cash flows of the tax effects of employee stock-based compensation awards that were outstanding upon the adoption of SFAS 123(R).

As highlighted above, the adoption of SFAS 123(R) had minimal effect on our financial results. In 2006, under SFAS 123(R), we began to record an estimate for expected forfeitures of restricted stock based on our historical forfeiture rates. Prior to adoption, we accounted for forfeitures as they occurred, as permitted under accounting standards then in effect. In addition, we shortened the vesting periods of certain stock-based awards based on the qualified retirement dates, as defined in our incentive compensation plans. The cumulative effect of adopting these changes was not material to our financial statements for the nine months ended September 30, 2006.

Stock-Based Incentive Compensation Plans Our stock-based incentive compensation plans provide for the granting of restricted stock awards to key members of management and the non-employee directors. Prior to 2003, we granted non-qualified stock options as stock-based incentive compensation (see below).

Our 2003 Incentive Plan, which provides for the granting of stock-based awards, including restricted stock awards, to key employees of Progressive, has 19.4 million shares currently authorized on a post-split basis, net of restricted stock awards cancelled; 13.5 million shares remain available for future restricted stock grants. Our 1995 Incentive Plan and 1989 Incentive Plan have expired; however, awards made under those plans prior to their respective expirations are still in effect.

In 2003, we began issuing restricted stock awards in lieu of stock options. The restricted stock awards are issued as either time-based or performance-based awards. The time-based awards vest in equal installments upon the lapse of a specified period of time, typically over three, four and five year periods. The vesting period (i.e., requisite service period) must be a minimum of six months and one day. The performance-based awards vest upon the achievement of predetermined performance goals. The performance-based awards are granted to approximately 50 executives and senior managers, in addition to their time-based awards, to provide additional compensation for achieving pre-established profitability and growth targets. Generally, the restricted stock awards are expensed pro rata over their

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respective vesting periods based on the market value of the awards at the time of grant. However, for restricted stock awards granted in 2003 and 2004 that were deferred pursuant to our deferred compensation plan, we record expense on a pro rata basis based on the current market value of Common Shares at the end of the reporting period; these awards are accounted for as liability awards.

Prior to 2003, we granted nonqualified stock options for terms up to ten years. These options became or will become exercisable at various dates not earlier than six months after the date of grant, and remain exercisable for specified periods thereafter. All options granted had an exercise price equal to the market value of the Common Shares on the date of grant and, under the then applicable accounting guidance, no compensation expense was recorded. Pursuant to the adoption of SFAS 123(R), on January 1, 2006, we began expensing the remaining unvested stock option awards. All option exercises are settled in Progressive Common Shares from either existing treasury shares or newly issued shares.

A summary of all employee restricted stock activity during the period indicated follows:

	Nine Months Ended September 30, 2006	
Nonvested restricted stock outstanding	Number of Shares	Weighted Average Grant Date Fair Value
Beginning of period	5,442,988	$ 20.21
Add (deduct):		
Granted	1,789,759	26.55
Vested	(567,824)	16.60
Forfeited	(450,524)	21.75
End of period	6,214,399	$ 22.25
Available, end of period [1]	13,486,953	

[1] Represents shares available under the 2003 Incentive Plan, after the granting of restricted stock awards.

There were 447,608 non-deferred restricted stock awards which vested during the nine months ended September 30, 2006. The aggregate pre-tax intrinsic value of these non-deferred awards, based on the average of the high and low stock price on the day prior to vesting, was $5.6 million. There was no intrinsic value attributed to the 120,216 deferred restricted stock awards that vested during the nine months ended September 30, 2006, since, as previously discussed, these awards were granted in 2003 or 2004 and, therefore, were expensed based on the current market value at the end of each reporting period.

A summary of all employee stock option activity during the period indicated follows:

	Nine Months Ended September 30, 2006	
Nonvested stock options outstanding	Number of Shares	Weighted Average Grant Date Fair Value
Beginning of period	4,232,220	$ 4.76
Add (deduct):		
Vested	(3,053,352)	4.36
Forfeited	(88,338)	5.81
End of period	1,090,530	$ 5.82

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	Nine Months Ended September 30, 2006		
Options outstanding	Number of Shares		Weighted Average Exercise Price
Beginning of period	19,621,476	$	8.44
Add (deduct):			
Exercised	(3,867,095)		8.06
Forfeited	(222,398)		12.07
End of period	15,531,983	$	8.48
Exercisable, end of period	14,441,453	$	8.14

The total pre-tax intrinsic value of options exercised during the nine months ended September 30, 2006, was $70.5 million, based on the actual stock price at time of exercise.

During the nine months ended September 30, 2006, we recognized $18.7 million, or $12.2 million after taxes, of compensation expense related to our outstanding unvested restricted stock and stock option awards. At September 30, 2006, the total compensation cost related to unvested awards not yet recognized was $79.3 million. This compensation expense will be recognized into the income statement over the weighted-average period of 2.24 years.

The following employee stock options were outstanding or exercisable as of September 30, 2006:

	Number of Shares		Weighted Average Exercise Price		Aggregate Intrinsic Value (in millions)	Weighted Average Remaining Contractual Life
Options outstanding	15,531,983	$	8.48	$	249.4	3.42 years
Options exercisable	14,441,453	$	8.14	$	236.9	3.29 years

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on our closing stock price of $24.54 as of September 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. All of the exercisable options at September 30, 2006, were in-the-money.

See Item 5-Other Information in Part II of this Form 10-Q for details regarding the restricted stock awards granted during the third quarter 2006.

Note 3 *Supplemental Cash Flow Information* We paid income taxes of $534.0 million and $571.0 million during the nine months ended September 30, 2006 and 2005, respectively. Total interest paid was $63.6 million for both the nine months ended September 30, 2006 and 2005. Non-cash activity includes the liability for deferred restricted stock compensation (prior to the adoption of SFAS 123(R)) and the changes in net unrealized gains (losses) on investment securities.

Progressive implemented a 4-for-1 stock split in the form of a stock dividend to shareholders on May 18, 2006. We reflected the issuance of the additional Common Shares by transferring $585.9 million from retained earnings to the common stock account. All per share and equivalent share amounts were adjusted to give effect to the split. Treasury shares were not split.

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Note 4 *Debt* Debt at September 30 consisted of:

	2006		2005	
(millions)	Carrying Value	Market Value	Carrying Value	Market Value
7.30% Notes due 2006	$	$	$ 100.0	$ 101.9
6.375% Senior Notes due 2012	348.2	366.8	347.9	375.3
7% Notes due 2013	149.1	164.0	149.0	168.0
6 5/8% Senior Notes due 2029	294.3	323.5	294.2	334.1
6.25% Senior Notes due 2032	393.8	408.2	393.7	425.2
	$ 1,185.4	$ 1,262.5	$ 1,284.8	$ 1,404.5

Note 5 *Comprehensive Income* Total comprehensive income was $624.6 million and $287.5 million for the quarters ended September 30, 2006 and 2005, respectively, and $1,376.1 million and $1,057.5 million for the nine months ended September 30, 2006 and 2005, respectively.

Note 6 *Dividends* On September 30, 2006, we paid a quarterly dividend of $.00875 per Common Share to shareholders of record as of the close of business on September 8, 2006. The dividend was declared by the Board of Directors on August 18, 2006.

On October 13, 2006, the Board of Directors declared a quarterly dividend of $.00875 per Common Share payable December 31, 2006, to shareholders of record at the close of business on December 8, 2006. This will be our final quarterly dividend payment prior to moving to our annual variable dividend policy in 2007, with the first payout expected in early 2008.

Note 7 *Segment Information* Our Personal Lines business units write insurance for private passenger automobiles and recreational vehicles. Our Commercial Auto business unit writes primary liability and physical damage insurance for automobiles and trucks owned by small businesses. Our other-indemnity businesses primarily include writing professional liability insurance for community banks and managing our run-off businesses. Our service businesses include providing insurance-related services, primarily policy issuance and claims adjusting services for Commercial Auto Insurance Procedures/ Plans (CAIP), which are state-supervised plans serving the involuntary market. All revenues are generated from external customers.

Following are the operating results for the periods ended September 30:

