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GALLAGHER ARTHUR J & CO
Form 10-Q
November 13, 2001

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

☒ Quarterly report pursuant to section 13 or 15 (d) of the Securities
Exchange Act of 1934 for the quarterly period ended September 30, 2001 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 1-9761

ARTHUR J. GALLAGHER & CO.

(Exact name of registrant as specified in its charter)

DELAWARE

36-2151613

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

Two Pierce Place, Itasca, Illinois 60143-3141

(Address of principal executive offices) (Zip code)

(630) 773-3800

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year,
if changed since last report)

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 ☒ NO ☐

The number of outstanding shares of the registrant's Common Stock, \$1.00 par
value, as of September 30, 2001 was 84,700,220.

ARTHUR J. GALLAGHER & CO.

INDEX

Page No.

Part I. Financial Information:

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Item 1. Financial Statements (Unaudited):

Consolidated Statements of Earnings for the three-month and nine-month periods ended September 30, 2001 and 2000.....	3
Consolidated Balance Sheets at September 30, 2001 and December 31, 2000.....	4
Consolidated Statements of Cash Flows for the nine-month periods ended September 30, 2001 and 2000.....	5
Notes to Consolidated Financial Statements.....	6-11

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.....	12-18
---	-------

Part II. Other Information:

Item 6. Exhibits and Reports on Form 8-K.....	19
Signatures.....	20

- 2 -

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

ARTHUR J. GALLAGHER & CO.

CONSOLIDATED STATEMENTS OF EARNINGS (UNAUDITED)

	Three-month period ended September 30,		Nine-month Sep
	2001	2000	2001
	-----	-----	-----
	(in thousands, except per share)		
Operating Results			
Revenues:			
Commissions	\$ 136,180	\$ 120,985	\$ 380,504
Fees	84,422	73,533	238,413
Investment income and other:			
Investment income	4,330	8,283	17,470
Income from equity investments, partnerships and joint ventures	6,907	5,686	14,639
Other income	1,458	632	5,061
	-----	-----	-----
Total investment income and other	12,695	14,601	37,170
	-----	-----	-----

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Total revenues	233,297	209,119	656,087
Expenses:			
Salaries and employee benefits	114,843	103,145	336,180
Other operating expenses	68,176	60,332	196,072
Partnership investment expenses	8,259	-	18,971
	-----	-----	-----
Total expenses	191,278	163,477	551,223
	-----	-----	-----
Earnings before income taxes	42,019	45,642	104,864
Provision for income taxes	116	13,579	12,681
	-----	-----	-----
Net earnings	\$ 41,903	\$ 32,063	\$ 92,183
	=====	=====	=====
Net earnings per common share	\$.49	\$.38	\$ 1.09
Net earnings per common and common equivalent share	.47	.36	1.03
Dividends declared per common share	.130	.115	.390

See notes to consolidated financial statements.

-3-

ARTHUR J. GALLAGHER & CO.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	September 30, 2001

	(in thousands)
ASSETS	
Current assets:	
Cash and cash equivalents	\$ 124,238
Restricted cash	189,916
Premiums and fees receivable	402,756
Investment strategies - trading	48,712
Other	83,580

Total current assets	849,202
Marketable securities - available for sale	18,493
Deferred income taxes	48,925
Other noncurrent assets	180,406
Fixed assets	139,694
Accumulated depreciation and amortization	(93,677)

Net fixed assets	46,017

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Intangible assets - net	22,867

	\$ 1,165,910
	=====
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Premiums payable to insurance companies	\$ 618,185
Accrued salaries and bonuses	32,946
Accounts payable and other accrued liabilities	106,675
Unearned fees	18,074
Income taxes payable	474
Other	19,444

Total current liabilities	795,798
Other noncurrent liabilities	26,948
Stockholders' equity:	
Common stock - issued and outstanding 84,700 shares in 2001 and 84,540 shares in 2000	84,700
Capital in excess of par value	2,973
Retained earnings	261,920
Unearned deferred compensation	(3,625)
Accumulated other comprehensive earnings (loss)	(2,804)

Total stockholders' equity	343,164

	\$ 1,165,910
	=====

See notes to consolidated financial statements.

- 4 -

ARTHUR J. GALLAGHER & CO.

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

	Nine-month period
	2001

	(in thousands)
Cash flows from operating activities:	
Net earnings	\$ 92,183
Adjustments to reconcile net earnings to net cash provided by operating activities:	
Net gain on investments and other	(2,940)
Gain on sales of operations	(2,375)
Depreciation and amortization	13,977
Increase in restricted cash	(31,270)
Decrease in premiums receivable	38,229
Increase in premiums payable	13,206
Decrease in trading investments - net	4,524

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(Increase) decrease in other current assets	27,634)
Decrease in accrued salaries and bonuses	(5,329)
Decrease in accounts payable and other accrued liabilities	(10,055)
Decrease in income taxes payable	(9,393)
Tax benefit from issuance of common stock	18,560
Net change in deferred income taxes	(583)
Other	1,286

Net cash provided by operating activities	92,386

Cash flows from investing activities:	
Purchases of marketable securities	(10,286)
Proceeds from sales of marketable securities	19,470
Proceeds from maturities of marketable securities	271
Net additions to fixed assets	(15,557)
Proceeds from sales of operations	2,700
Other	(22,455)

Net cash used by investing activities	(25,857)

Cash flows from financing activities:	
Proceeds from issuance of common stock	22,102
Repurchases of common stock	(67,147)
Dividends paid	(30,580)
Borrowings on line of credit facilities	95,700
Repayments on line of credit facilities	(90,700)
Equity transactions of pooled companies prior to dates of acquisition	(13,497)

Net cash used by financing activities	(84,122)

Net (decrease) increase in cash and cash equivalents	(17,593)
Cash and cash equivalents at beginning of period	141,831

Cash and cash equivalents at end of period	\$ 124,238
	=====
Supplemental disclosures of cash flow information:	
Interest paid	\$ 955
Income taxes paid	12,627

See notes to consolidated financial statements.

- 5 -

ARTHUR J. GALLAGHER & CO.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Nature of Operations and Basis of Presentation

Arthur J. Gallagher & Co. (Gallagher) provides insurance brokerage and risk management services to a wide variety of commercial, industrial, institutional and governmental organizations. Commission revenue is principally generated through the negotiation and placement of insurance for its clients. Fee revenue is primarily generated by providing other risk management services including claims management, information management, risk control services and appraisals in either the property/casualty market

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or human resource/employee benefit market. Investment income and other is generated from Gallagher's investment portfolio, which includes fiduciary funds, equity securities, and tax advantaged and other strategic investments. Gallagher is headquartered in Itasca, Illinois, has more than 200 offices in nine countries and does business in more than 100 countries around the world through a network of correspondent brokers and consultants.

The accompanying unaudited consolidated financial statements have been prepared by Gallagher pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements have been omitted pursuant to such rules and regulations. Gallagher believes the disclosures are adequate to make the information presented not misleading. The unaudited consolidated financial statements included herein are, in the opinion of management, prepared on a basis consistent with the audited consolidated financial statements for the year ended December 31, 2000 and include all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the information set forth. The quarterly results of operations are not necessarily indicative of results of operations for subsequent quarters or the full year. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in Gallagher's 2000 Annual Report on Form 10-K.

2. Effect of New Pronouncements

In 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 133 (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities," as amended, which was effective for fiscal years beginning after June 15, 2000. Because of Gallagher's minimal use of derivatives, the effect of the adoption of SFAS 133 in the first quarter of 2001 was not material to Gallagher's consolidated operating results or financial position.

In June 2001, the FASB issued Statements of Financial Accounting Standards No. 141 (SFAS 141), "Business Combinations," and No. 142 (SFAS 142), "Goodwill and Other Intangible Assets."

SFAS 141 eliminates the pooling of interests method of accounting for business combinations except for qualifying business combinations that were initiated prior to July 1, 2001. In addition, SFAS 141 further clarifies the criteria to recognize intangible assets separately from goodwill. The requirements of SFAS 141 are effective for any business combination accounted for by the purchase method that is completed after June 30, 2001 (i.e., the acquisition date is July 1, 2001 or after). Gallagher initiated several business combinations prior to July 1, 2001 that were completed in the third quarter of 2001 and were accounted for as poolings of interests because they met the qualifying criteria of SFAS 141.

Under SFAS 142, goodwill and indefinite lived intangible assets will no longer be amortized, but will be subject to periodic review for impairment (at least annually or more frequently if impairment indicators arise). Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives. The amortization provisions of SFAS 142 will apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, companies will be required to adopt SFAS 142 in their fiscal year beginning after

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ARTHUR J. GALLAGHER & CO.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

2. Effect of New Pronouncements (Continued)

December 15, 2001 (i.e., January 1, 2002 for calendar year companies). Because of the different transition dates for goodwill and intangible assets acquired on or before June 30, 2001 and those acquired after that date, pre-existing goodwill and intangibles will be amortized during this transition period (June 30, to December 31, 2001) until adoption whereas new goodwill and indefinite lived intangible assets acquired after June 30, 2001 will not be amortized.

Gallagher will apply the new rules on accounting for pre-existing goodwill and other intangible assets beginning in the first quarter of 2002. Management has not yet determined the effect on net earnings of the application of the nonamortization provisions of SFAS 142. During 2002, Gallagher will perform the first of the required impairment tests of goodwill and indefinite lived intangible assets as of January 1, 2002 and has not yet determined what the effect of these tests will be on Gallagher's operating results or financial position.

3. Business Combinations

During the nine-month period ended September 30, 2001, Gallagher acquired substantially all of the net assets of the following insurance brokerage firms in exchange for shares of its common stock: The Galtney Group, Inc. dba Healthcare Insurance Services, 3,330,000 shares; MDM Insurance Associates, Inc., 752,000 shares; The InWest Group, Inc., 407,000 shares; SKANCO International, Ltd., 263,000 shares; Nelson/Monarch Insurance Services, Ltd., 109,000 shares; E.S. Susanin, Inc., 109,000 shares; Burgess & Associates, Inc., 73,000 shares; Madison Scott & Associates, Inc., 34,000 shares; Midwest Surety Services, Inc., 32,000 shares; and Central Surety Agency, Inc., 26,000 shares. These acquisitions were accounted for as poolings of interests and, except for three of these acquisitions whose results were not significant, the consolidated financial statements for all periods prior to the acquisition dates have been restated to include the operations of these companies. The following summarizes the restatement of the 2000 consolidated financial statements to reflect the operations of the 2001 acquisitions (in thousands, except per share data):

Three-month period ended September 30, 2000	As Previously Reported	Attributable to Pooled Companies	As Restated
Total revenues	\$ 197,078	\$ 12,041	\$ 209,119
Net earnings	31,341	722	32,063
Net earnings per common share	.40	(.02)	.38
Net earnings per common and common equivalent share	.37	(.01)	.36
Nine-month period ended September 30, 2000			
Total revenues	\$ 532,137	\$ 42,306	\$ 574,443
Net earnings	63,824	4,513	68,337
Net earnings per common share	.82	-	.82
Net earnings per common and			

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common equivalent share .77 - .77

- 7 -

ARTHUR J. GALLAGHER & CO.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

3. Business Combinations (Continued)

Effective May 1, 2001, Gallagher acquired substantially all of the net assets of Texas Insurance Agency, Inc.-Houston, an insurance brokerage firm, in exchange for an initial cash payment of \$4.6 million and a contingent obligation of \$1.5 million. This acquisition was accounted for as a purchase and was not material to the consolidated financial statements.

4. Insurance Company Receivables and Payables

A reinsurance intermediary subsidiary of Gallagher includes only amounts relating to brokerage commission revenue in premiums and fees receivable in the accompanying consolidated balance sheets. The premiums and claims receivable and payable, as well as the related excise taxes payable, associated with the reinsurance brokerage commission revenue, are not included in the accompanying consolidated balance sheets because they are not assets and liabilities of Gallagher. The excluded amounts are as follows (in thousands):

	September 30, 2001	December 31, 2000
	-----	-----
Premiums and claims:		
Receivable	\$ 446,832	\$ 373,764
Payable	452,887	378,166

The differences between the receivable and payable balances represent fiduciary funds received by the reinsurance intermediary subsidiary, which are included in restricted cash and premiums payable to insurance companies in the accompanying consolidated balance sheets.

- 8 -

ARTHUR J. GALLAGHER & CO.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

5. Earnings Per Share

The following table sets forth the computation of net earnings per common share and net earnings per common and common equivalent share (in thousands, except per share data):

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	Three-month period ended September 30,		Nin
	2001	2000	
	-----	-----	---
Net earnings	\$ 41,903	\$ 32,063	\$
	=====	=====	=====
Weighted average number of common shares outstanding	84,785	84,001	
Dilutive effect of stock options using the treasury stock method	5,289	5,662	
	-----	-----	---
Weighted average number of common and common equivalent shares outstanding	90,074	89,663	
	=====	=====	=====
Net earnings per common share	\$.49	\$.38	\$
Net earnings per common and common equivalent share	.47	.36	

Options to purchase 141,000 shares of common stock were outstanding at September 30, 2001, but were not included in the computation of the dilutive effect of stock options for the three-month period then ended. Options to purchase 345,000 and 134,000 shares of common stock were outstanding at September 30, 2001 and 2000, respectively, but were not included in the computation of the dilutive effect of stock options for the nine-month period then ended. These options were excluded from the computations because the options' exercise prices were greater than the average market price of the common shares during the respective periods and, therefore, would be antidilutive to earnings per share under the treasury stock method.

- 9 -

ARTHUR J. GALLAGHER & CO.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED) (Continued)

6. Comprehensive Earnings

The components of comprehensive earnings and accumulated other comprehensive earnings (loss) are as follows (in thousands):

	Three-month period ended September 30,		Nine-month peri September
	2001	2000	2001
	-----	-----	-----
Net earnings	\$ 41,903	\$ 32,063	\$ 92,183
Net change in unrealized gain (loss) on available for sale securities, net of income taxes of (\$630), \$362, (\$204) and \$470, respectively	(945)	543	(306)
	-----	-----	-----
Comprehensive earnings	\$ 40,958	\$ 32,606	\$ 91,877
	=====	=====	=====
Accumulated other comprehensive			

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earnings (loss) at beginning of period	\$ (1,859)	\$ (2,507)	\$ (2,498)	\$
Net change in unrealized gain (loss) on available for sale securities, net of income taxes	(945)	543	(306)	
Accumulated other comprehensive earnings (loss) at end of period	\$ (2,804)	\$ (1,964)	\$ (2,804)	\$

7. Deferred Compensation

In 2001, Gallagher adopted the Deferred Equity Participation Plan, which is a non-qualified plan that provides for distributions to certain key executives of Gallagher upon their normal retirement. Under the provisions of the plan, Gallagher contributes shares of its common stock, in an amount approved by Gallagher's Board of Directors, to a rabbi trust on behalf of the executives participating in the plan. Distributions under the plan normally may not be made until the participant retires after reaching age 62 and are subject to forfeiture in the event of voluntary termination of employment prior to age 62. All distributions from the plan are made in the form of Gallagher's common stock.

In June 2001, Gallagher contributed \$4.0 million to the plan through the issuance of 152,000 shares of Gallagher common stock. Gallagher accounts for the common stock issued to the plan in accordance with the provisions of Emerging Issues Task Force (EITF) Issue No. 97-14, "Accounting for Deferred Compensation Arrangements Where Amounts Earned are Held in a Rabbi Trust and Invested." EITF 97-14 requires that the Gallagher common stock issued to the trust be valued at historical cost (fair market value at the date of grant) and the unearned deferred compensation obligation be classified as an equity instrument, with no recognition of changes in the fair value of the amount owed to the participants. The unearned deferred compensation balance is shown as a reduction of stockholders' equity in the accompanying 2001 consolidated balance sheet and is being amortized ratably over the vesting period of the participants. During the nine-month period ended September 30, 2001, \$375,000 was charged to expense related to this plan.

- 10 -

ARTHUR J. GALLAGHER & CO.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED) (Continued)

8. Quarterly Operating Results

Quarterly operating results for 2000, as restated for the 2001 acquisitions accounted for as poolings of interests, were as follows (in thousands, except per share data):

	1st	2nd	3rd	4th
Revenues:				
Commissions	\$110,268	\$109,233	\$120,985	\$129,758
Fees	64,428	64,587	73,533	78,687

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Investment income and other:				
Investment income	5,786	6,012	8,283	5,871
Income from equity investments, partnerships and joint ventures	1,380	2,907	5,686	4,212
Other income	618	105	632	2,302
	-----	-----	-----	-----
Total investment income and other	7,784	9,024	14,601	12,385
	-----	-----	-----	-----
Total revenues	182,480	182,844	209,119	220,830
Expenses:				
Salaries and employee benefits	96,545	98,075	103,145	116,607
Other operating expenses	55,801	58,548	60,332	72,481
Partnership investment expenses	-	-	-	-
	-----	-----	-----	-----
Total expenses	152,346	156,623	163,477	189,088
	-----	-----	-----	-----
Earnings before income taxes	30,134	26,221	45,642	31,742
Provision for income taxes	11,019	9,062	13,579	7,124
	-----	-----	-----	-----
Net earnings	\$ 19,115	\$ 17,159	\$ 32,063	\$ 24,618
	=====	=====	=====	=====
Net earnings per common share	\$.23	\$.21	\$.38	\$.29
Net earnings per common and common equivalent share	.22	.19	.36	.27

- 11 -

Item 2.

ARTHUR J. GALLAGHER & CO.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS - CONSOLIDATED

Fluctuations in premiums charged by insurance companies have a direct and potentially material effect on the insurance brokerage industry. Commission revenues are generally based on a percentage of the premiums paid by insureds and therefore, normally follow premium levels. The tragic events in the United States on September 11, 2001 have reshaped the insurance marketplace much faster than expected. Larger than anticipated loss experience, stock market declines, lower interest rates and diminished risk capacity have led to unprecedented short term premium rate increases across all lines. Higher premium rates are referred to as a "hardening of the market" and generally result in increased commission revenues. Since the beginning of the year, Gallagher has seen a trend toward higher premium rates which has contributed to its overall revenue growth in the third quarter and year-to-date 2001. Management believes a hard market will continue for the foreseeable future. Although a hardening of the market overall contributes positively to Gallagher's results, its future effect on

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Gallagher's business is difficult to predict.

In a period of rising insurance costs, certain "risk" buyers will move toward the alternative insurance market, which would tend to have a favorable effect on Gallagher's Risk Management Services segment. Gallagher anticipates that new sales and renewal increases in areas of risk management, claims management, insurance captives and self-insurance will continue to be a major factor in Gallagher's fee revenue growth during 2001, which could adversely impact the growth in commission revenues.

During the nine-month period ended September 30, 2001, Gallagher acquired substantially all of the net assets of eleven insurance brokerage firms, ten of which were accounted for as poolings of interests. For seven of the acquisitions that were accounted for as poolings of interests, Gallagher's results of operations for all periods presented have been restated as if they had operated as part of Gallagher prior to their acquisition dates. Gallagher continues to search for merger partners which complement existing operations, provide entry into new markets, add new products and enhance local sales and service capabilities. For the effect of these restatements, in the aggregate, on period to period comparisons, see Note 3 to the Consolidated Financial Statements. In June 2001, the FASB issued SFAS 141 which eliminates the pooling-of-interests method of accounting for business combinations except for qualifying business combinations that were initiated prior to July 1, 2001. Gallagher initiated several business combinations prior to July 1, 2001 that were completed in the third quarter of 2001 and were accounted for as poolings of interests because they met the qualifying criteria of SFAS 141. See Note 2 to the Consolidated Financial Statements.

Commission revenues increased by 13% to \$136.2 million in the third quarter of 2001 and by 12% to \$380.5 million in the first nine months of 2001 over the respective periods in 2000. These increases are due principally to new business production of \$28.4 million in the third quarter of 2001 and \$69.2 million in the first nine months of 2001, and to renewal increases from increased premiums partially offset by lost business and a reduction in revenue from national insurance revenue-sharing programs.

Fee revenues increased by 15% or \$10.9 million to \$84.4 million in the third quarter of 2001 and by 18% or \$35.9 million to \$238.4 million in the first nine months of 2001 over the respective periods in 2000. These increases, generated primarily by the Risk Management Services segment, reflect new business production of approximately \$11.0 million in the third quarter of 2001 and \$38.2 million in the first nine months of 2001, and renewal rate increases partially offset by lost business.

Investment income and other in the third quarter of 2001 decreased \$1.9 million or 13% to \$12.7 million from the same period in 2000. This decrease is due primarily to a \$5.4 million net gain on the installment sale of a synthetic fuel facility recognized in the third quarter of 2000, which was partially offset by a \$4.0 million dollar installment gain recognized on the sale of a synthetic fuel facility in the third quarter of 2001.

- 12 -

ARTHUR J. GALLAGHER & CO.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

RESULTS OF OPERATIONS - CONSOLIDATED (Continued)

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During the third quarter of 2001, Gallagher entered into a transaction for the sale of a 95% interest in one of its synthetic fuel facilities located in South Carolina. Under the sale agreement, Gallagher received an initial nonrefundable down payment of \$6.7 million and will receive further installment payments over time through 2007 based on qualified fuel production generated by the facility. The buyer has the option to put the purchased interest back to Gallagher if favorable tax rulings are not received by March 1, 2003. In such case, Gallagher would retain the down payment and installment payments made through the put date. The aggregate pretax gain on the transaction is expected to range from \$36.0 million to \$106.0 million and will be recognized on an installment basis through December 31, 2007.

In October 2001, Gallagher completed the sale of a two-thirds interest in a partnership that owns a 59.9% interest in a synthetic fuel facility located in South Carolina. The sale agreement provides for an initial down payment of \$3.2 million with further installment payments over time through 2007 based on qualified fuel production generated by the facility. The buyer has the option to put the purchased interest back to Gallagher if favorable tax rulings are not received by March 30, 2002 or if certain adverse tax consequences occur through December 31, 2007. In such case, Gallagher would retain all installment payments made through the put date and a pro-rated portion of the initial down payment. The aggregate pretax gain on the transaction is expected to range from \$48.0 million to \$70.0 million and will be recognized on an installment basis through December 31, 2007. The buyer also has the option, through March 31, 2002, to acquire from Gallagher another one-sixth interest in the partnership at proportionally equivalent terms. This sale transaction had no impact on Gallagher's third quarter results.

The United States Treasury Department is continuing its review of the Internal Revenue Code Section that governs qualified synthetic production, and no assurance can be given that such review will not result in changes that could adversely affect the two installment sale transactions discussed above.

In the first nine months of 2001, investment income and other increased 18% or \$5.8 million to \$37.2 million over the respective period in 2000. This increase is due primarily to the results generated by Gallagher's unconsolidated equity investment portfolio, realized gains generated from Gallagher's marketable securities portfolio and the sale transactions discussed below. In 2001, Gallagher recorded \$3.0 million of income related to its proportionate share of income from an equity investment in a real estate partnership that is currently developing land in Florida. Gallagher also recognized gains in 2001 of \$800,000 on the sale of an interest in a limited partnership that operates qualified affordable housing projects and \$2.4 million on the sale of a benefit administration book of business. These increases were partially offset by the \$1.4 million net difference in gains on the installment sales of the synthetic fuel facilities discussed above.

Salaries and employee benefits increased by 11% or \$11.7 million to \$114.8 million in the third quarter of 2001 and increased by 13% or \$38.4 million to \$336.2 million in the first nine months of 2001 over the respective periods in 2000. These increases are higher than usual and reflect salary increases and associated employee benefit costs, increases in incentive compensation linked to Gallagher's overall operating results and the performance of Gallagher's investment portfolio, and a 9% increase in employee headcount in the period from September 30, 2000 to September 30, 2001. The increase in employee headcount relates to the hiring of additional staff to support the new business growth previously discussed and to an ongoing initiative to hire additional production personnel to generate future revenue growth.

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ARTHUR J. GALLAGHER & CO.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

RESULTS OF OPERATIONS - CONSOLIDATED (Continued)

Other operating expenses increased by 27% or \$16.1 million to \$76.4 million in the third quarter of 2001 and by 23% or \$40.4 million to \$215.0 million in the first nine months of 2001 over the respective periods in 2000. These increases are due primarily to start up costs, fees for professional services, business insurance and ongoing expenses related to the operations of synthetic fuel facilities (partnership investment expenses) and to performance-related investment fees. In addition, Gallagher experienced increases in expenses in 2001 related to increased leased space, temporary help needed to service new risk management and claims business and commissions paid to sub-brokers.

The effective income tax rate was essentially 0% for the third quarter and 12% for the first nine months of 2001 and 30% for the third quarter and 33% for the first nine months of 2000. These rates are net of the effect of tax credits generated by investments in alternative energy related partnerships that operate synthetic fuel facilities and limited partnerships that operate qualified affordable housing, which are partially offset by state and foreign taxes. The reductions in the effective income tax rates in 2001 from the prior year reflect an increase in tax credits earned in 2001 from the alternative energy projects.

Net earnings per common and common equivalent share increased by 31% or \$.11 to \$.47 in the third quarter of 2001 and by 34% or \$.26 to \$1.03 in the first nine months of 2001 over the respective periods in 2000. These increases are primarily due to the decrease in the effective income tax rate in 2001 from the same period in 2000 and also reflect the previously discussed, revenue increases and investment gains.

- 14 -

ARTHUR J. GALLAGHER & CO.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

RESULTS OF OPERATIONS - SEGMENT INFORMATION

Financial information relating to Gallagher's operating segments is as follows (in thousands):

	Insurance Brokerage Services -----	Risk Management Services -----	Financial Services -----	Corporate -----
Three-month period ended ----- September 30, 2001 -----				
Total revenues	\$ 155,407	\$ 67,812	\$10,078	\$ -
Earnings (loss) before income taxes	35,878	10,079	(2,052)	(1,886)

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September 30, 2000

Total revenues	138,591	60,682	9,846	-
Earnings (loss) before income taxes	30,759	9,939	5,367	(423)

Nine-month period ended

September 30, 2001	431,080	198,900	26,258	(151)
Earnings (loss) before income taxes	84,916	28,003	(1,788)	(6,267)

September 30, 2000

Total revenues	386,280	171,528	16,635	-
Earnings (loss) before income taxes	68,010	27,310	8,756	(2,079)

Total Identifiable Assets at

September 30, 2001	733,877	72,901	245,574	113,558
September 30, 2000	669,848	58,991	245,111	63,788

Insurance Brokerage Services

The Insurance Brokerage Services segment encompasses operations that, for commission or fee compensation, place or arrange to place insurance directly related to the clients' managing of risk. This segment also provides consulting, for fee compensation related to the clients' risk financing programs and includes Gallagher's retail, reinsurance and wholesale insurance brokerage operations.

Total revenues for this segment in the three and nine-month periods ended September 30, 2001 increased 12% to \$155.4 million and 12% to \$431.1 million, respectively, over the same periods in 2000. These increases are due principally to new business of approximately \$28.4 million and \$69.2 million, respectively, and renewal rate increases partially offset by lost business and a reduction in revenue from national insurance revenue-sharing programs. Earnings before income taxes for this segment in the three and nine-month periods ended

- 15 -

ARTHUR J. GALLAGHER & CO.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

RESULTS OF OPERATIONS - SEGMENT INFORMATION (Continued)

Insurance Brokerage Services (Continued)

September 30, 2001 increased 17% to \$35.9 million and 25% to \$84.9 million, respectively, over the same periods in 2000. These increases are due primarily to the new business production and rate increases mentioned above.

Risk Management Services

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The Risk Management Services segment includes Gallagher's third party administration, loss control and risk management consulting, workers' compensation investigations and insurance property appraisal operations. Third party administration is principally claims management programs for Gallagher's clients or clients of other brokers.

Total revenues for this segment in the three and nine-month periods ended September 30, 2001 increased 12% to \$67.8 million and 16% to \$198.9 million over the respective periods in 2000 due primarily to new business production of approximately \$11.0 million and \$38.2 million, respectively, and renewal rate increases partially offset by lost business. Earnings before income taxes for this segment in the three and nine-month periods ended September 30, 2001 increased 1% to \$10.1 million and 3% to \$28.0 million, respectively, over the same periods in 2000. These increases are due primarily to the earnings leverage created by the increased revenues discussed above significantly offset by increased costs for personnel and systems conversions.

Financial Services

The Financial Services segment is responsible for the management of Gallagher's diversified investment portfolio, which includes fiduciary funds, marketable and other equity securities, and tax advantaged and other strategic investments. The non-fiduciary invested assets of Gallagher are combined in this segment in order to maximize the return to the company.

Total revenues for this segment in the three-month period ended September 30, 2001 were essentially flat compared to the prior year due primarily to the \$1.4 million net difference in gains on the installment sales of the synthetic fuel facilities mentioned above. Total revenues for this segment in the nine-month period ended September 30, 2001 increased 58% to \$26.3 million over the respective period in 2000. This increase is due primarily to the results generated by Gallagher's unconsolidated equity investment portfolio, realized gains generated from Gallagher's marketable securities portfolio and sale transactions discussed below. In 2001, Gallagher recorded \$3.0 million of income related to its proportionate share of income from an equity investment in a real estate partnership that is currently developing land in Florida. Gallagher also recognized gains in 2001 of \$800,000 on the sale of an interest in a limited partnership that operates qualified affordable housing projects and \$2.4 million on the sale of a benefit administration book of business. Earnings (loss) before taxes for this segment in the three and nine-month periods ended September 30, 2001 decreased \$7.4 million to a loss of \$2.1 million and \$10.5 million to a loss of \$1.8 million, respectively. These decreases are due primarily to increases in start up costs, fees for professional services, business insurance and ongoing expenses related to the operations of synthetic fuel facilities (partnership investment expenses); incentive compensation linked to the performance of Gallagher's investment portfolio; and performance-related investment fees. The tax credits earned by Gallagher from these facilities have increased significantly in 2001, which resulted in a reduction of Gallagher's effective income tax rates in 2001 from the prior year.

- 16 -

ARTHUR J. GALLAGHER & CO.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

RESULTS OF OPERATIONS - SEGMENT INFORMATION (Continued)

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Corporate

The Corporate segment consists of unallocated administrative costs and the provision for income taxes which is not allocated to Gallagher's operating entities. Only revenues not attributable to one of the three operating segments are recorded in the Corporate segment. All costs are generated in the United States.

FINANCIAL CONDITION AND LIQUIDITY

The insurance brokerage industry is not capital intensive. Gallagher has historically been profitable and cash flows from operations and short-term borrowings under various credit agreements have been sufficient to fund Gallagher's operating, investment and capital expenditure needs. Cash generated from operating activities was \$92.4 million and \$108.5 million for the nine months ended September 30, 2001 and 2000, respectively. Because of the variability related to the timing of premiums and fees receivable and premiums payable, net cash flows from operations vary substantially from quarter to quarter. Funds restricted as to Gallagher's use, primarily premiums held as fiduciary funds, have not been included in determining Gallagher's overall liquidity.

In 2000, Gallagher and one of its significant subsidiaries entered into an unsecured revolving credit agreement (the Revolving Credit Agreement), which expires on September 10, 2003, with a group of five financial institutions. The Revolving Credit Agreement provides for short-term and long-term revolving credit commitments of \$100.0 million and \$50.0 million, respectively. The facility provides for loans and letters of credit. Letters of credit are limited to \$75.0 million of which up to \$50.0 million may be issued under the long-term facility and up to \$25.0 million may be issued under the short-term credit facility in the determination of net funds available for future borrowing. As of September 30, 2001, under the long-term credit facility, Gallagher has contingently committed to funding \$52.3 million through letter of credit arrangements related to its corporate insurance programs and several of its equity and other strategic investments. During the nine-month period ended September 30, 2001, Gallagher borrowed \$95.7 million and repaid \$90.7 million of short-term borrowings under this facility. These borrowings were used on a short-term basis to finance a portion of Gallagher's operating and investment activity. As of September 30, 2001, \$5.0 million was outstanding under the short-term credit facility. The Revolving Credit Agreement requires the maintenance of certain financial covenants and Gallagher was in compliance with these covenants as of September 30, 2001.

Through the first nine months of 2001, Gallagher paid \$30.6 million in cash dividends on its common stock. Gallagher's dividend policy is determined by the Board of Directors. Quarterly dividends are declared after considering Gallagher's available cash from earnings and its anticipated cash needs. On October 15, 2001, Gallagher paid a third quarter dividend of \$.13 per share to shareholders of record as of September 28, 2001, a 13% increase over the third quarter dividend per share in 2000.

Net capital expenditures were \$15.6 million and \$12.3 million for each of the nine-month periods ended September 30, 2001 and 2000, respectively. Gallagher expects to make total capital expenditures of approximately \$17.0 million in 2001. Capital expenditures by Gallagher are related primarily to office moves and expansions and updating computer systems and equipment.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

FINANCIAL CONDITION AND LIQUIDITY (Continued)

In 1988, Gallagher adopted a common stock repurchase plan that has been extended through June 30, 2002. Under the plan, Gallagher has repurchased 2.5 million shares at a cost of \$72.8 million in the first nine months of 2001. The repurchased shares are held for reissuance in connection with exercises of options under its stock option plans. Under the provisions of the repurchase plan, Gallagher is authorized to repurchase approximately 3.2 million additional shares through June 30, 2002. Gallagher is under no commitment or obligation to repurchase any particular amount of common stock and at its discretion may suspend the repurchase plan at any time.

SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This report contains forward-looking statements. Forward-looking statements made by or on behalf of Gallagher are subject to risks and uncertainties, including but not limited to the following: Gallagher's commission revenues are highly dependent on premiums charged by insurers, which are subject to fluctuation; lower interest rates reduce Gallagher's income earned on invested funds; the alternative insurance market continues to grow which could unfavorably impact commission and favorably impact fee revenue; Gallagher's revenues vary significantly from period to period as a result of the timing of policy inception dates and the net effect of new and lost business production; the general level of economic activity can have a substantial impact on Gallagher's renewal business; Gallagher's operating results, return on investment and financial position may be adversely impacted by exposure to various market risks such as interest rate, equity pricing, foreign exchange rates and the competitive environment, and changes in income tax laws. Gallagher's ability to grow has been enhanced through acquisitions, which may or may not be available on acceptable terms in the future and which, if consummated, may or may not be advantageous to Gallagher. Accordingly, actual results may differ materially from those set forth in the forward-looking statements.

- 18 -

ARTHUR J. GALLAGHER & CO.

PART II - OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

- a. Exhibit 10.8.3 - Arthur J. Gallagher & Co. and AJG Financial Services, Inc. Third Amendment to Credit Agreement Dated as of September 7, 2001.
- Exhibit 10.8.4 - Arthur J. Gallagher & Co. and AJG Financial Services, Inc. Fourth Amendment to Credit Agreement Dated as of November 7, 2001.
- b. Reports on Form 8-K. No Reports on Form 8-K were filed during the three-month period ended September 30, 2001.

- 19 -

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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 on the 13th day of November, 2001.

ARTHUR J. GALLAGHER & CO.

/s/ Michael J. Cloherty

Michael J. Cloherty
Executive Vice President
Chief Financial Officer

/s/ Richard C. Cary

Richard C. Cary
Controller
Chief Accounting Officer

- 20 -