

Equity Research

FINANCIAL
Insurance

May 06, 2008
Research Note

Ticker: AGII
Market: NASDAQ
Price: \$37.78
52-week: (\$33-\$51)

Stock Rating:
Outperform

Company Profile:
Aggressive Growth

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Argo Group International Holdings, Ltd.

Highlights of First Quarter – Lower Tax Rate Drives Big Upside – Making Progress

FINANCIAL SUMMARY

Fiscal Year Ends:	December	Dividend/Yield:	\$0.00/0.0%
Long-term EPS Growth Rate:	12%	Market Value (mil.):	\$1,087

FISCAL YEAR	2006A	2007E	2008E
ESTIMATES *			
Earnings Per Share	NA	NA	\$4.30
VALUATION			
Price/Earnings Ratio	NA	NA	8.8x

* Estimates reflect the adoption of FAS 123R.

Highlights

> Argo Group reported operating EPS (excluding net realized investment gains) of about \$1.17 compared with the consensus of \$0.96. Our estimate was \$0.86, but was not included in the consensus EPS estimate. All of the upside relative to consensus was driven by a lower tax rate given a tax benefit associated with the sale of a reinsurance company acquired in the PXRE merger. A normalized tax rate of about 25% would put operating EPS at \$0.97 per share. The additional upside relative to our estimate was driven by lower expenses and higher favorable loss reserve development. The quality and relative transparency of results were better relative to the past few quarters, in our opinion.

> Gross written premium increased 21%, to \$347 million, given the inclusion of one large new program account and to a lesser extent a recent acquisition (about 12% excluding these factors). Excess and surplus lines (E&S) declined 12%, to \$160.1 million; specialty commercial increased 39%, to \$137.3 million; and international specialty was \$50.3 million (started following the PXRE merger) compared with \$6.8 million—the latter amounting to about 50% of the company's new business goal in 2008 for this new unit. Within specialty commercial, an acquisition added \$7 million and the large program account added \$18 million—14% growth excluding these factors. We are looking for modest growth overall for the rest of the year excluding the Heritage acquisition, driven by international specialty and some growth in specialty commercial, offsetting continued pressure within the E&S segment. Price competition continued to intensify during the quarter, as underwriters react to record underwriting margins over the past two years and we see no reasonable scenario to prevent competition from continuing to intensify over the next several quarters.

> The combined ratio was 95.9% this quarter compared with 95.2% last quarter and 94.2% in first quarter 2007. The loss ratio was 60.2% compared with 57.9% in first quarter 2007, and the expense ratio was 35.8% compared with 36.3%. Underwriting income included favorable loss development from prior years' reserves of \$6.7 million (3.1 percentage points) compared with \$9.1 million of favorable loss development in the first quarter of 2007 (4.2 percentage points). Given the inclusion of the international specialty business and more volatile underwriting margins, comparing loss ratios with past periods is less relevant on a consolidated basis. Management stated that accident year loss ratios are being booked 1 to 2 percentage points higher, generally consistent with trends for the overall industry, and management expects the expense ratio to decline modestly for the balance of the year.

> Argo Group announced on April 2 an agreement to purchase Heritage Underwriting Agency, a U.K.-based and listed commercial property-casualty underwriter, for \$272 million in cash. The deal is expected to close before the end of the second quarter and we expect the deal to be funded through cash on the balance sheet and the company's credit facility. When the deal was announced, we increased our 2008 EPS estimate to \$4.10 from \$3.80 per share and our 2009 EPS estimate to \$5.00 from \$4.35 per share, which still results in a return on equity (ROE) of less than 10% in 2009. While the deal looks to make financial sense, looks to be generally a good use of capital, and adds diversification, we are not big fans of commercial property insurance with catastrophe exposure. The property catastrophe business has historically been a lower price-to-book-value-per-share business and is volatile, thus reducing earnings visibility, everything else equal. Commercial property insurance can also be a more volatile business even when excluding catastrophe exposure, given the potential for high severity losses on individual exposures.

> More aggressive capital management and expense management are key catalysts for the stock over the next few quarters. The company repurchased just \$5.1 million of stock after the end of the quarter and we expect share repurchases to remain opportunistic and management to more precisely refine its capital management plan with a new CFO. Management has its hands full with the Heritage acquisition, the much smaller acquisition of Massamont Insurance Agency announced in early March, and the very complex PXRE merger completed in August 2007. The Heritage and Massamont deals should absorb most of Argo Group's excess capital, particularly if management has plans to increase its underwriting participation in these businesses in 2009. We do not expect any additional deals of size in the near term. We believe the key factor in improving capital management is unlocking the capital that is attached to the company's run off operations—A&E, workers' compensation, and the PXRE property catastrophe reserves.

> The company finally hired a new chief financial officer, Jay Bullock, the former head of Bear Stearns insurance investment banking group. Given this new hire and recent activities, we hope management will be able to lay out a more refined capital management plan over the next quarter or two.

> We have increased our 2008 EPS estimate to \$4.30 from \$4.10 given the tax benefit this quarter, and we are leaving our 2009 EPS estimate at \$5.00, which represents an ROE of less than 10%, slightly above excluding OCI.

> Our rating remains Outperform. We remain selective within commercial property-casualty despite below-average valuation given continued increasing price competition and deterioration in underlying profitability that will eventually lead to earnings disappointments—the only major positive we see for the stocks is the inevitability of further consolidation.

We have been disappointed in the progress Argo Group has made communicating the benefits of the actions taken over the past 12 to 18 months, including the recent agreement to purchase Heritage Underwriting in the United Kingdom. That said, we continue to view Argo Group as a special situation value play that has several levers to pull in order to unlock underlying value—including reducing expenses, releasing further excess capital and more aggressively repurchasing stock, and reporting easier-to-understand financial results. The shares trade at an 18% discount to diluted book value per share of \$46.20 per share as of March 31, 2008.

Management has stated recently that it would become clearer over the next few quarters how Argo Group would chart its course to generate a midteens ROE. While that task appears to be a challenge to us, Argonaut does not need to generate a midteens ROE in 2009 in order for the stock to recover to book value per share and outperform the market.

William Blair & Company, L.L.C. is a market maker in the security of Argo Group International Holdings, Ltd. and may have a long or short position.

Additional information is available upon request.



Current Rating Distribution (as of 04/30/08)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	59	Outperform (Buy)	12
Market Perform (Hold)	40	Market Perform (Hold)	6
Underperform (Sell)	1	Underperform (Sell)	1

*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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