

Argo Group International Holdings, Ltd.

Second-Quarter Results, Making More Progress

Highlights

- We estimate that Argo Group reported second-quarter operating EPS of about \$1.26, which excludes realized investment loss, a small intangible asset impairment, and foreign exchange translation losses. Our estimate excluding foreign exchange translation losses was \$1.21. Management provided an operating EPS figure of \$1.31 and the consensus estimate was \$1.13. The upside relative to our estimate was driven by several factors, including higher net investment income and higher fee income.
- Gross written premiums increased 44%, to \$572 million, given the benefits from the Heritage acquisition (international specialty segment), which exceeded our estimate. However, management has not provided enough information on the impact from foreign currency movements to accurately forecast Heritage's business yet, in our opinion. Management stated that growth was up modestly on a pro forma basis for the acquisition and on a constant currency basis, slightly ahead of our estimate, given modest growth within international specialty on an underlying basis, as well as strong production in reinsurance. In addition, Heritage recognized \$17 million of additional premium from certain programs written in prior years. Heritage's results are included from June 1, 2008. Pricing continues to stabilize more broadly, but we do not expect a sharper recovery until underlying profitability for the industry comes under more significant pressure.
- The combined ratio was 95.8%, compared with 96.2% last quarter, our 95.5% estimate, and 99.4% in second quarter 2008, which included above-average catastrophe losses. The combined ratio excluding favorable loss development outside of international specialty (Heritage) and storm losses was 96.3%, compared with our 95.3% estimate, given continued poor results at Heritage. Heritage recorded \$22 million of adverse loss reserve development, but this was offset by the additional \$17 million collected on business written in prior periods.
- Net realized investment losses were \$9.2 million pretax, down from \$11.8 million last quarter, \$16.8 million in fourth quarter 2008, and \$18.4 million in third quarter 2008—off of a \$4 billion portfolio. Diluted book value per share increased more than 5% during the quarter, to \$47.51 per share, given the recovery in credit markets.
- We are increasing our 2009 EPS estimate to \$4.39 from \$4.14 and our 2010 EPS estimate to \$4.90 from \$4.45.

Financial | Commercial P/C Insurance

August 05, 2009

Stock Rating: **Outperform**
Company Profile: **Aggressive Growth**

Symbol: AGII (NASDAQ)
Price: \$35.47 (52-Wk.: \$24-\$43)
Market Value (mil.): \$1,065
Fiscal Year End: December
Long-Term EPS Growth Rate: 12%
Dividend/Yield: None

	2008A	2009E	2010E
Estimates			
EPS Q1	\$1.17	A\$1.13	NA
Q2	\$0.77	A\$1.26	NA
Q3	\$0.10	\$0.84	NA
Q4	\$0.76	\$1.16	NA
FY	\$2.81	\$4.39	\$4.80
CY		\$4.39	\$4.80

Valuation			
FY P/E	12.6x	8.1x	7.4x
CY P/E		8.1x	7.4x

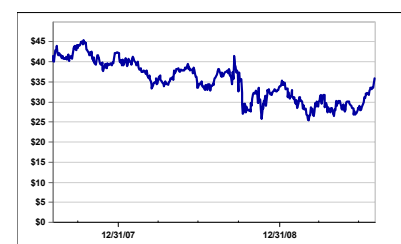
Trading Data (Thomson Financial)

Shares Outstanding (mil.)	31
Float (mil.)	30
Average Daily Volume	187,426

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	20.6
Book Value Per Share (MRQ)	46.4
Enterprise Value (mil.)	1,528.1
EBITDA (TTM)	186.4
Enterprise Value/EBITDA (TTM)	8.2x
Return on Equity (TTM)	3.8

Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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- Our rating remains Outperform. While we have been more cautious on commercial property-casualty insurance overall, we like Argo Group because we believe the company has several opportunities for better expense management and more aggressive capital management as its run-off businesses wind down, which should positively drive margins higher. The shares still trade at about a 25% discount to second quarter 2009 diluted book value per share and we believe the stock could easily trade closer to book value per share as underlying profitability improves and earnings visibility increases over the next several quarters.

Discussion

EPS Upside Nice, Better Results Consistent With Last Quarter, Upside Not as Strong as It Appears

We estimate that Argo Group reported second-quarter operating EPS of about \$1.26, which excludes \$0.55 per share of realized investment loss, a small intangible asset impairment, and foreign exchange translation losses. Our estimate excluding foreign exchange translation losses was \$1.21. Management provided an operating EPS figure of \$1.31 and the consensus estimate was \$1.13, although we do not know how other analysts treated foreign exchange losses and management has yet to provide the specific tax impact from nonoperating items. Management's operating EPS estimate is based on a reasonably expected effective tax rate. The company has never split foreign exchange translation losses (Argo Group does not hedge) from its operating results until this quarter given the size of the impact. We believe that the translation loss should not be excluded from operating earnings despite the fact that there is a positive offsetting impact on the balance sheet, although the impact should be adjusted when considering the core earnings power of the company. Importantly, the quality and earnings upside in the quarter could have been much better for not the continued drag from the Heritage acquisition. The annualized operating return on equity was 10.9% compared with 10.1% in the first quarter, but better than 6.2% reported for all of 2008. Management needs to drive the ROE consistently above 15.0% over the cycle to be considered a high quality, specialty lines franchise, in our opinion.

Premium Growth Above Expectations, Surprises Us a Bit Besides Reinsurance Segment

Gross written premiums increased 44%, to \$572 million, given the benefits from the Heritage acquisition (international specialty), which exceeded our estimate as we have underestimated the contribution from Heritage. However, management has not provided enough information on the impact from foreign currency movements to accurately forecast Heritage's business yet, in our opinion. While management talks about the book in terms of British pounds sterling, the business is collected in more than one currency and characterizing the business in British pounds sterling is also subject to foreign currency translations, complicating any analysis. In addition, Heritage recognized \$17 million of additional premium from certain programs written in prior years. Heritage's earnings results are included from June 1, 2008, and therefore this will be the last quarter for which year-over-year comparisons will be distorted by premium growth and underwriting margin comparisons. Heritage's business is property driven with catastrophe exposures, and therefore loss ratios are more volatile on a quarterly basis. That said, because Heritage was marginally profitable from an underwriting perspective this quarter, the impact to earnings from higher premium growth was minimal. Gross written premium increased 5%, to \$340 million, excluding the international specialty segment compared with our 0% growth estimate given slightly better growth in excess and surplus lines and commercial specialty and much better growth in reinsurance, the latter we assume given Argo Group's emerging position in the space and better pricing in certain areas.

Although the market is showing some signs of rate stabilization, improvements are materializing slowly and are highly variable by line of business—largely concentrated within reinsurance and property. Our basic view on commercial property-casualty insurance pricing since mid-September 2009 has been that underlying underwriting margins were still too high for the commercial property-casualty insurance industry to push for price increases aggressively despite capital pressures, which we believe has been generally accurate. Therefore, we believe the primary catalyst toward a further push in pricing is further deterioration in underlying margins and profitability after more than four consecutive years of price declines.

Excess and surplus lines (E&S) gross written premiums declined 2%, to \$176 million, versus our \$171 million estimate—down 5% in the first half. Casualty pricing remains under pressure, although less so than the last two quarters, and the economy is hurting exposure growth in this segment particularly. Commercial specialty gross written premiums increased 1%, to \$102.4 million, compared with our \$101.0 million—down 10% in the first half given the nonrenewal of one large account and the loss of another low margin, “fronted” account. Management stated that growth in the quarter was constrained by competition in the grocery segment and the public entity business. Reinsurance gross written premiums increased 36%, to \$60.0 million, with prices up modestly—up 21% in the first half. While property reinsurance rates are up in the aggregate including the catastrophe business, management stated that its appetite remains somewhat limited this year at current price levels. The reinsurance business performed respectably in its first full year in operation in 2008 following the acquisition of PXRE in August 2007 and the hiring of a new chief underwriter in late 2007, writing \$126 million of gross written premium with a combined ratio of 78.0% in 2008.

Management stated that international specialty showed slight growth in gross written premium on a constant currency basis excluding the additional premium collected from prior periods and on a pro forma basis for the Heritage acquisition (included from June 1, 2009). Argo Group has increased the participation in the Lloyd's business to 62% this year from 54% in 2008, although that change does not affect gross written premiums. International specialty is a Lloyd's business that was the former Heritage operation, which has been renamed recently. Argo Group hired the head of CNA's (CAN \$20.64) European operations two months ago to run its international specialty segment. His first priority is to optimize the profitability of the current book of business (he stated the current book is about £400 million). Over time, he believes there are opportunities to expand product breadth within the traditional Lloyd's businesses, expand into the London market directly, and expand into Continental Europe, the latter most likely in 2010.

Underwriting Margins Weighed Down by Underperformance at Heritage, Disappointment So Far

The combined ratio was 95.8% this quarter, compared with 96.2% last quarter, our 95.5% estimate, and 99.4% in second quarter 2008, which included above-average catastrophe losses. The combined ratio excluding favorable loss development outside of Heritage (\$6.5 million) and storm losses (\$4.9 million) was 96.3% compared with our 95.3% estimate given continued poor results at Heritage. Heritage recorded \$22 million of adverse loss reserve development, but this was offset by an additional \$17 million collected on business written in prior periods. A lower expense ratio relative to our estimate mitigated the drag from Heritage's higher loss ratio. Expense management remains a focus and a seasonally lower expense ratio within international specialty helped push the expense ratio lower—the expense ratio was 33.2% compared with 37.1% in first quarter 2009 and our 35.6% estimate. Management stated early in the year that its goal for 2009 is to maintain flat levels of nonacquisition expense, suggesting that the only way that its expense ratio can improve is to grow the business, which will be somewhat challenging given its business mix, in our opinion.

Favorable loss reserve development overall was \$6.5 million excluding Heritage, reducing the loss ratio by 1.7 percentage points—our estimate was \$8.0 million. The loss ratio was 62.6% compared with 59.2% in the first quarter 2009 and our 59.9% estimate, given weaker results at Heritage (65.9% loss ratio in international specialty), some adverse loss reserve development within the public entity business within commercial specialty, and higher accident-year loss ratio picks in certain segments within commercial specialty. The legacy loss reserves remained in check this quarter. Storm losses were \$4.9 million compared with our \$9 million estimate. The loss ratio excluding development/catastrophe losses (and outside of Heritage) was higher than we expected at 63.0% compared with 59.5% in first quarter 2009 and our 59.7% estimate given poor results at Heritage and higher accident-year loss ratios. Accident year profitability remains under pressure given overall pressure on pricing on top of four consecutive years of pricing reductions.

Heritage recorded \$22 million of adverse loss reserve development this quarter alone, but this was offset by the additional \$17 million collected on business written in prior periods, so the net impact was much less. The results of Heritage following the closing of the acquisition have been disappointing and unsettling, in our opinion. The international specialty segment generated \$25 million of underwriting losses in second half 2009, including above-average catastrophe losses. However, last quarter management stated that it continued to work through repositioning this business, stating the quality

and profitability of the business has improved through the reunderwriting process and should help results moving forward.

Realized Investment Losses More Manageable; Capital Is Not an Issue—Management Taking Conservative Position

The company realized a \$9.2 million net pretax loss in its investment portfolio, down from \$11.8 million last quarter, \$16.8 million in fourth quarter 2008, and \$18.4 million in third quarter 2008—off of a \$4 billion portfolio. Diluted book value per share increased more than 5% during the quarter, to \$47.51 per share, given the recovery in credit markets. Most property-casualty companies have seen some deterioration in their investment portfolios, given the deteriorating credit and equity markets, but in general the deterioration has been small compared with life insurers that tend to have lower-quality portfolios and have taken a larger hit to book value on a comparative basis. While Argo Group remains well capitalized, management is clearly taking a more conservative stance regarding capital management in the near term—consistent with industry peers. Argo announced its first ever share repurchase authorization earlier in 2008, but has not repurchased any stock so far.

Raising Estimates, Reiterate Outperform Rating

We are increasing our 2009 EPS estimate to \$4.39 from \$4.14 and our 2010 EPS estimate to \$4.90 from 4.45. The increase is largely due to a higher net earned premium contribution from Heritage. Our second half 2009 EPS estimate includes \$0.90 per share of catastrophe losses (2.7 percentage points on the combined ratio for the year) and \$0.40 per share of favorable loss reserve development. We stress that Argo Group's earnings are the least visible of any insurance company we cover given recent acquisitions, recent volatility, an above-average catastrophe loss exposure within our universe, a continued legacy loss reserve exposure, and now the impact from foreign exchange.

We remain selective in the space given what we view as an imminent deterioration in industrywide profitability due to nearly five consecutive years of price declines. That said, we view valuation near trough historical valuation levels as limiting any downside. While we have been more cautious on commercial property-casualty insurance overall given that we expect underlying profitability to come under more severe pressure before we see a broad, material improvement in price, we like Argo Group because we believe the company has several opportunities for better expense management and more aggressive capital management as its run-off businesses wind down that should positively drive margins higher. Importantly, while the stock has been stronger the past few weeks given the recognition of some of this value, the shares still trade at about a 25% discount to second quarter 2009 book value per share of \$47.51.

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 7/31/2009)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	59	Outperform (Buy)	2
Market Perform (Hold)	40	Market Perform (Hold)	1
Underperform (Sell)	1	Underperform (Sell)	0

*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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