

First Mercury Financial Corporation

First Look at Second-Quarter Results, Disappointing But Not Disastrous

—Highlights

- Second-quarter results below expectations given storm-related losses and above-average property losses during the quarter.** First Mercury reported second-quarter operating EPS of \$0.30, \$0.11 below our estimate and \$0.12 below consensus. Results included storm losses in the quarter of \$2.4 million pretax (\$0.09 per share after-tax), above-average property losses of \$5.2 million pretax (\$0.19 per share after-tax), offset somewhat by roughly \$5.5 million pretax (\$0.13 per share after-tax) of favorable loss reserve development (reductions in loss estimates for business written in prior years) in the quarter. Excluding these items, operating EPS were \$0.45, given higher commissions and net investment income relative to our estimate, offset by a higher loss ratio and expense ratio and lower net earned premium. While we view the results as disappointing, we do not view the results as disastrous. It is the nature of the smaller insurance companies to experience some periods of volatility in underwriting results as they typically lack the breadth and diversity of larger insurance companies, which are better positioned to absorb above-average losses in a particular area. First Mercury's second-quarter conference call is scheduled for 11:00 a.m. EST on August 4.
- Habitational property losses principal culprit for shortfall; business has been cut with modest remaining exposure.** The \$5.2 million of above-average property losses related principally to the company's habitational property class of business, a portion of which is underwritten through FM Emerald, and a portion underwritten through contract underwriters (non-First Mercury employees). In response to the losses, the company has implemented significantly more-conservative underwriting standards for its property business, limiting new business growth within this segment, and completely canceled its contract underwriting relationship with the producing managing underwriter (roughly \$20 million to \$25 million). Management believes that the claims deterioration in this segment may be economically related. However, these losses are a disappointment because this is a business that the company started within the last two years, despite the fact that the underwriters responsible for the business had long-term experience in the class. Outside of its roughly \$25 million legal liability book, we were not aware that the company had outside underwriting relationships. Management stated that it has three other contract underwriting relationships outside of its legal liability business that total about \$10 million. Importantly, First Mercury only has roughly \$12.8 million of unearned premium reserve outstanding related to its overall property business, which is expected to run-off over the next year (contract underwriting firm that has been cancelled also wrote general liability business).

Financial | Commercial P/C Insurance

August 04, 2009

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

Symbol: FMR (NYSE)
Price: \$14.74 (52-Wk.: \$8-\$16)
Market Value (mil.): \$259
Fiscal Year End: December
Long-Term EPS Growth Rate: 15%
Dividend/Yield: None

	2008A	2009E	2010E
Estimates			
EPS FY	\$1.74	\$1.70	\$1.95
CY		\$1.70	\$1.95
Valuation			
FY P/E	8.5x	8.7x	7.6x
CY P/E		8.7x	7.6x

Trading Data (Thomson Financial)

Shares Outstanding (mil.)	18
Float (mil.)	15
Average Daily Volume	130,821

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	22.0
Book Value Per Share (MRQ)	13.1
Enterprise Value (mil.)	316.7
EBITDA (TTM)	43.0
Enterprise Value/EBITDA (TTM)	7.4x
Return on Equity (TTM)	14.5

Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

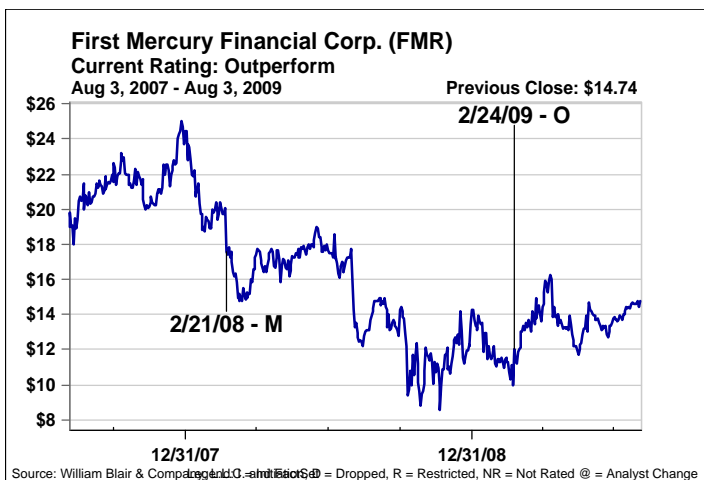
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- **Realized investment gains contributed to growth in book value.** Second-quarter GAAP EPS were \$0.64, including the impact from a \$6.2 million realized after-tax gain (\$9.5 million pretax) on the company's investment portfolio (approximately \$0.34 per share). This compares with \$1.8 million of pretax realized investment gains last quarter. Fully diluted book value per share ended the quarter at \$15.90, up 5% from first quarter 2009, and tangible book value increased 6.6%, to \$12.37, from first quarter 2009. The company repurchased roughly 390 million shares of common stock during the second quarter for \$5.1 million, and as of June 30, 2009, has approximately 415 million shares still eligible for repurchase through its share buy-back program set to expire August 18, 2009.
- **Achieved top-line growth despite curtailment of segments of property business.** Gross premiums written increased 3% to \$82.5 million, compared with our estimate of 2% growth, 3.4% growth in second quarter 2008, and negative 4.1% last quarter. Growth was driven by the launch of a new specialty business unit at the end of 2007 (FM Emerald—80% year-over-year premium growth to \$15.1 million) and the inclusion of the new Professional Liability business unit launched February 2009. The core security business declined 18% to \$14 million, given competitive pressures, and the core specialty segment was down 10%, to \$34 million, given a reduction in the contractors business, which has been hurt by a weaker economy. We expect to cut our premium growth estimate modestly, given a more stable, yet still competitive market environment and the reduction in the modest property business.
- **Increase in combined ratio reflective of abnormal losses, underlying remain under pressure as well.** The combined ratio was 99.9%, compared with our 89.9% estimate and 84.0% in second quarter 2008. The loss ratio, 69.0%, was significantly higher than our 59.4% estimate, given the storm and property losses mentioned above. We estimate the loss ratio excluding the storm losses, above-average property losses, and favorable loss reserve development was 61.2%. The expense ratio, 30.9%, was essentially in line with our 30.4% estimate.
- **Management reduced 2009 guidance; maintain Outperform rating; expect to trim estimates.** Management reduced its 2009 operating EPS guidance range from \$1.60-\$1.75 to \$1.30-\$1.60 to account for the underperformance this quarter (\$0.15) and some modest potential adverse development on the remaining property book. Our rating remains Outperform, and we will revise our estimates after the conference call. We expect to lower our \$1.70 2009 EPS estimate to at or below the midpoint of management's range. The shares trade at roughly an 8% discount to diluted book value, and we see no reason why First Mercury should not trade at a modest premium to book value today, given its profitability and growth profile, even in light of recent property-related losses.

William Blair & Company, L.L.C. is a market maker in the security of First Mercury Financial Corporation and may have a long or short position.

Additional information is available upon request.



Current Rating Distribution (as of 8/3/2009)

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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