HCC Insurance Holdings, Inc.

First-Quarter Results Mixed, Nonrecurring Gains Driving Upside

Highlights

- First-quarter operating EPS increased 6%, to $0.73, compared with our $0.69 per share estimate and consensus of $0.69 per share. Realized investment losses were minimal given generally high credit quality within the investment portfolio. The outperformance relative to our estimate was driven completely by the nonrecurring commutation of the MGIC (MTG $4.63) reinsurance contract announced last week ($0.09 per share after-tax).

- Net written premium was flat in the quarter at $491 million, relatively in line with our estimate. Production in the quarter was driven by growth within diversified financial products, which includes directors' and officers' liability coverage—an area of the market that has shown the greatest rate price increases to date. Pricing continues to stabilize overall, but we do not expect a sharper recovery until underlying profitability for the industry comes under more significant pressure.

- The combined ratio was 87.3%, compared with our 85.8% estimate—$4.7 million of adverse loss reserve development added a modest 0.9 percentage points to the loss ratio, and losses in other specialty lines were also elevated given some larger losses. The adverse development in the quarter was attributed to smaller, noncore lines of business that were acquired over the past few years in the life, accident, and health lines segment. The loss ratio was 62.8% compared with our estimate of 60.5%—our estimate included $12.5 million of favorable loss reserve development.

- The company announced that its current president, John Molbeck, will replace current CEO Frank Bramanti, who is retiring. The timing of Mr. Bramanti's retirement is somewhat surprising and we expected a new CEO to come from outside the organization. Mr. Molbeck has been with HCC off and on since 1997, and given his intimate familiarity with the organization, we do not see major changes in store.

- We have increased our 2009 EPS estimate to $2.80 from $2.75 given the outperformance this quarter. Management's EPS guidance range remains $2.65 to $2.85 with no anticipated benefits from favorable loss reserve development, which continue to be included within our estimate.

- Our rating remains Market Perform. We view HCC as a high-quality, stable underwriter that should continue to benefit from a flight to quality. The shares trade at roughly 1.02 times first quarter 2009 diluted book value per share of $24.19, and while we view valuation as attractive on an absolute basis, we see more relative value within the space.

Financial | Commercial P/C Insurance

May 06, 2009

Stock Rating:	**Market Perform**
Company Profile:	**Core Growth**

Symbol:	HCC (NYSE)
Price:	$24.27 (52-Wk.: $14-$30)
Market Value (mil.):	$2,780
Fiscal Year End:	December
Long-Term EPS Growth Rate:	15%
Dividend/Yield:	$0.51/2.1%

	2008A	2009E	2010E
Estimates			
EPS Q1	$0.70	A$0.73	NA
Q2	$0.81	$0.70	NA
Q3	$0.61	$0.68	NA
Q4	$0.69	$0.69	NA
FY	$2.80	$2.80	$2.95
CY		$2.80	$2.95
Valuation			
FY P/E	8.7x	8.7x	8.2x
CY P/E		8.7x	8.2x

Trading Data (Thomson Financial)

Shares Outstanding (mil.)	114
Float (mil.)	111
Average Daily Volume	1,720,682

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	12.6
Book Value Per Share (MRQ)	21.9
Enterprise Value (mil.)	2,910.6
EBITDA (TTM)	466.9
Enterprise Value/EBITDA (TTM)	6.2x
Return on Equity (TTM)	11.6

Two-Year Price Performance Chart

Source: Thomson Financial, William Blair & Company estimates

Mark Lane
312.364.8686
mlane@williamblair.com

Rachel Carter
312.364.8962
rcarter@williamblair.com

Respectable EPS Upside Driven by Nonrecurring Gains

First-quarter operating EPS increased 6%, to $0.73, compared with our $0.69 per share estimate and consensus of $0.69 per share. Realized investment gains/losses were minimal after reaching above-average levels the past few quarters. The outperformance relative to our estimate this quarter was driven completely by the nonrecurring commutation of the MGIC (MTG $4.63) reinsurance contract announced last week, translating into $15.6 million of pretax income, or $0.09 per share after-tax. The shortfall relative to our estimate excluding the MGIC commutation was driven by higher losses. The operating return on equity (ROE) was a solid 12.5%.

Stable Premium, Continued Growth in Directors' and Officers' Liability Insurance

Net written premium was flat in the quarter at $491 million, compared with our negative 1% growth estimate—currency translation has a slight negative impact on reported growth. Pricing continues to stabilize in the aggregate, but we do not expect a sharper recovery until underlying profitability for the industry comes under more significant pressure. Production in the quarter was driven by growth within the company's diversified financial products line, which includes directors' and officers' liability coverage—an area of the market that has shown the greatest rate increase to date and is going through dramatic changes with the capital pressures and employee departures at AIG (AIG $1.84), Hartford (HIG $15.07), and XL Capital (XL $10.53)—three major players in D&O. HCC could take huge share in the D&O business if the company has the appetite given that it is now one of only two double-A rated, publicly traded insurance companies (the other is Chubb [CB $40.13]). In diversified financial products, net written premiums increased 13%, to $203 million (41% of total). Life, accident, and health net written premium was down 2% in the quarter, to $199 million (41% of total), given some pressure on exposure growth given the weak economy, with pricing continuing to run modestly in excess of trend according to management and unique within the broader industry. Aviation declined 5% in the quarter, to $42 million, with improving conditions overall; the London Market Account (offshore energy, marine, and property) declined 9%, to $26 million; and other specialty lines saw a reduction of 36% due in part to the expiration of a quota share reinsurance contract in the segment (Argo Group's [AGII $28.19] E&S business).

Management continues to provide what we believe is a candid and accurate assessment of the existing rate environment, indicating that rate improvements remain varied by line of business, although the overall market has yet to turn meaningfully. HCC is seeing continued large rate increases in financial institution professional liability, Gulf of Mexico offshore energy, and international aviation—less than 15% of the company's business. Management remains hopeful that all lines will experience price improvements by the second half of 2009—affecting the bottom line in 2010. 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.

Margins Remain Attractive, but Losses Elevated; Credit Sensitive Lines a Drag

The combined ratio was 87.3%, compared with our 85.8% estimate—$4.7 million of adverse loss reserve development added a modest 0.9 percentage points to the loss ratio (compared with $24 million and a 4.8 percentage point reduction last quarter) and losses in other specialty lines were also elevated. The expense ratio was 24.5% compared with our 25.3% estimate. The adverse development in the quarter was attributed to smaller, noncore lines of business that were acquired over the past few years in the life, accident, and health lines segment. The loss ratio was 62.8% (61.9% excluding reserve development) compared with our estimate of 60.5% (63.0% excluding reserve development) and 59.4% in first quarter 2009 (64.2% excluding reserve development). Underlying profitability was stronger in the aggregate given a mix shift toward the diversified financial products segment, which carries a lower-than-average loss ratio. Accident-year loss ratios by line of business were generally higher given deterioration in profitability due to continued pressure on pricing, or claims inflation in more economically sensitive lines of business, including D&O. There was no major movement across accident-year loss reserves within the D&O business. The last few quarters the company has taken up current accident-year loss reserves within D&O by offsetting favorable development in earlier years. We expect continued favorable loss reserve development in 2009 with continued pressure on accident-year loss ratios even in areas with price increases.

Realized Investment Losses Minimal, Capital Is Not an Issue

Realized investment losses totaled only $58,000 compared with $9.2 million last quarter and $17.2 million in third quarter 2008 (in excess of $4 billion portfolio). We may see some additional small, realized losses over the next few quarters, but credit quality remains generally high for HCC and most of the commercial property-casualty insurance industry and we do not see credit as a serious concern. HCC has significantly “de-risked” its investment portfolio over the past 12 months, exiting its remaining equity and equity-related investments at the end of first quarter 2009. Municipals constitute 50% of the fixed income portfolio, with 2% overall rated below investment grade. Structured credit is less than 5% of the total and predominantly triple-A rated. Management expects to generate approximately $300 million of earnings in 2009, with net written premiums increasing by a few percentage points, thus generating more excess capital. HCC is one of the few companies in the space that continued to buy back stock during the quarter given its high financial flexibility, repurchasing $35 million worth of stock. Consistent with its conservative capital management stance, management has stated in the past that it would not repurchase shares at levels greater than book value.

Bumping Up 2009, Rating Remains Market Perform Given Better Value Within Space

We have increased our 2009 EPS estimate to $2.80 from $2.75 given the outperformance this quarter. Management’s EPS guidance range remains $2.65 to $2.85 with no anticipated benefits of favorable loss reserve development. The consensus EPS estimate was $3.00 before the company established guidance last quarter. Management’s guidance was based on gross written premium of $2.5 billion (flat from 2008 levels), net written premium of $2.1 billion (also flat from 2008 levels), and a combined ratio of 86.5% (compared with 85.4% in 2008), and does not include a catastrophe loss provision; catastrophe losses totaled $22.5 million in 2008.

We view HCC as a high-quality, stable underwriter that should continue to benefit from a flight to quality as one of only two double-A-rated commercial property-casualty insurance companies in the United States. The potential for higher near-term D&O liability losses remains a key concern for the company, in our opinion. The shares trade at roughly 1.04 times first quarter 2009 diluted book value per share of $24.19 and while we view this as very attractive on an absolute basis, we see more relative value within the space. In addition, 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 prices.

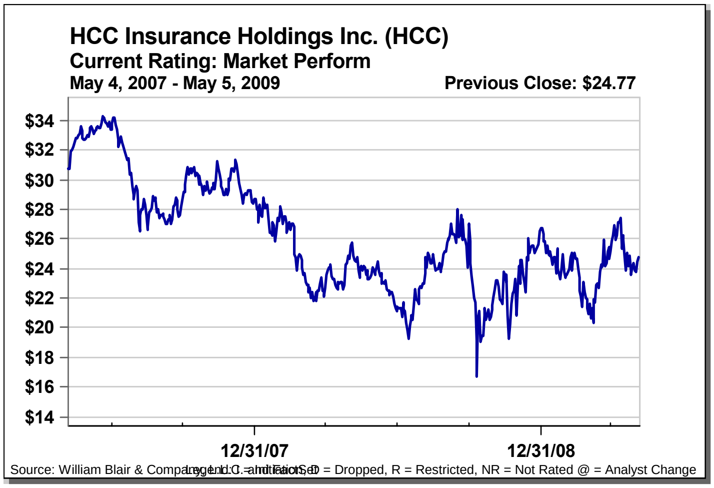
HCC Insurance Holdings, Inc.
Condensed Income Statement Comparison
($ in millions, except per share data)

	1Q08	2Q08	3Q08	4Q08	2008 Actual	1Q09	2Q09E	3Q09E	4Q09E	2009 Estimate	2010 Estimate
Gross written premium	**$582,999**	**$691,593**	**$612,964**	**$611,207**	**$2,498,763**	**$602,387**	**$691,718**	**$653,218**	**$659,513**	**$2,606,835**	**$2,828,693**
% change annual	*-3%*	*4%*	*3%*	*3%*	*2%*	*3%*	*0%*	*7%*	*8%*	*4%*	*9%*
Net written premium	**$493,647**	**$567,150**	**$495,585**	**$504,236**	**$2,060,618**	**$491,250**	**$566,210**	**$543,149**	**$552,985**	**$2,153,594**	**$2,349,155**
% change annual	*-1%*	*6%*	*6%*	*4%*	*4%*	*0%*	*0%*	*10%*	*10%*	*5%*	*9%*
% gross written premium	*85%*	*82%*	*81%*	*82%*	*82%*	*82%*	*82%*	*83%*	*84%*	*83%*	*83%*
Premiums earned	$493,546	$506,610	$504,972	$502,646	$2,007,774	$502,388	$519,438	$512,766	$522,305	$2,056,896	$2,201,374
% change annual	*-1%*	*2%*	*2%*	*0%*	*1%*	*2%*	*3%*	*2%*	*4%*	*2%*	*7%*
Losses and LAE incurred	$293,026	$302,901	$324,506	$291,440	$1,211,873	$315,566	$314,260	$316,889	$315,994	$1,262,709	$1,342,838
% premiums earned	*59.4%*	*59.8%*	*64.3%*	*58.0%*	*60.4%*	*62.8%*	*60.5%*	*61.8%*	*60.5%*	*61.4%*	*61.0%*
Favorable/(unfavorable) reserve development	$5,100	$9,300	$44,000	$24,000	$82,400	($4,700)	$7,500	$7,500	$5,000	$15,300	$7,500
% premiums earned	*1.0%*	*1.8%*	*8.7%*	*4.8%*	*4.1%*	*-0.9%*	*1.4%*	*1.5%*	*1.0%*	*0.7%*	*0.3%*
Policy acquisition costs	$92,268	$95,845	$96,582	$96,746	$381,441	$88,692	$98,693	$97,425	$99,238	$384,049	$413,858
% premiums earned	*18.7%*	*18.9%*	*19.1%*	*19.2%*	*19.0%*	*17.7%*	*19.0%*	*19.0%*	*19.0%*	*18.7%*	*18.8%*
Underwriting expense	$59,204	$57,514	$57,702	$59,089	$233,509	$68,998	$61,475	$61,054	$60,088	$251,615	$253,985
% of operating revenue less NII	*11.4%*	*10.5%*	*10.5%*	*11.2%*	*10.9%*	*12.4%*	*11.2%*	*11.2%*	*11.0%*	*11.4%*	*10.9%*
Expense ratio	*24.3%*	*24.3%*	*23.7%*	*27.6%*	*25.0%*	*24.5%*	*25.3%*	*25.3%*	*25.0%*	*25.0%*	*25.0%*
Underwriting income	**$49,048**	**$50,350**	**$26,182**	**$55,371**	**$180,951**	**$29,132**	**$45,010**	**$37,397**	**$46,984**	**$158,523**	**$190,692**
% change annual	*-3%*	*-4%*	*-56%*	*81%*	*-6%*	*-41%*	*-11%*	*43%*	*-15%*	*-12%*	*20%*
Underwriting margin	*23.7%*	*23.1%*	*17.9%*	*19.8%*	*21.1%*	*19.9%*	*21.3%*	*20.2%*	*21.6%*	*20.7%*	*21.0%*
Combined ratio	**83.7%**	**84.1%**	**88.0%**	**85.6%**	**85.3%**	**87.3%**	**85.8%**	**87.1%**	**85.5%**	**86.4%**	**86.0%**
Fees and commissions	$30,999	$30,764	$37,795	$25,643	$125,201	$30,294	$26,919	$31,181	$23,079	$111,472	$111,472
% change annual	*-4%*	*-1%*	*-12%*	*-25%*	*-11%*	*-2%*	*-13%*	*-18%*	*-10%*	*-11%*	*0%*
Noninsurance company expenses	$31,540	$30,253	$34,606	$17,105	$113,503	$34,605	$28,750	$28,750	$28,750	$120,855	$117,500
% change annual	*8%*	*11%*	*-1%*	*-61%*	*-16%*	*10%*	*-5%*	*-17%*	*68%*	*6%*	*-3%*
Fee-based income	($541)	$511	$3,189	$8,538	$11,698	($4,311)	($1,832)	$2,431	($5,671)	($9,383)	($6,028)
% change annual	*-119%*	*-87%*	*-59%*	*-184%*	*167%*	*696%*	*-458%*	*-24%*	*-166%*	*-180%*	*-36%*
Fee-based margin	*-2.1%*	*1.2%*	*7.5%*	*34.9%*	*8.7%*	*-8.1%*	*-6.1%*	*7.1%*	*-21.7%*	*-6.5%*	*-4.9%*
Net investment income	$47,621	$47,249	$35,962	$33,919	$164,751	$45,218	$46,787	$47,006	$46,954	$185,965	$193,722
% change annual	*-4%*	*-3%*	*-28%*	*-42%*	*-20%*	*-5%*	*-1%*	*31%*	*38%*	*13%*	*4%*
Other income	($4,946)	$10,947	$4,828	($1,191)	$9,638	$22,896	$3,000	$3,000	$3,000	$31,896	$12,000
Total operating revenues	**$567,220**	**$595,570**	**$583,557**	**$561,017**	**$2,307,364**	**$600,796**	**$596,143**	**$593,952**	**$595,337**	**$2,386,229**	**$2,518,568**
% change annual	*-5%*	*0%*	*0%*	*-7%*	*-3%*	*6%*	*0%*	*2%*	*6%*	*3%*	*6%*
Pretax operating margin	*20.8%*	*22.5%*	*14.4%*	*17.8%*	*18.9%*	*20.4%*	*19.6%*	*19.2%*	*19.4%*	*19.6%*	*19.5%*
Interest expense	$4,953	$3,808	$3,750	$4,771	$17,282	$4,639	$4,800	$4,800	$4,800	$19,039	$18,000
Income before income taxes	$117,937	$133,782	$83,779	$99,820	$435,318	$122,843	$116,916	$113,784	$115,217	$468,759	$489,887
Provision for income taxes	$37,482	$41,445	$24,726	$27,543	$131,196	$39,673	$36,829	$35,842	$36,293	$148,637	$151,865
Effective tax rate	*31.8%*	*31.0%*	*29.5%*	*27.6%*	*30.1%*	*32.3%*	*31.5%*	*31.5%*	*31.5%*	*31.7%*	*31.0%*
Net income	$80,455	$92,337	$59,053	$72,277	$304,122	$83,170	$80,087	$77,942	$78,924	$320,123	$338,022
% change annual	*-17%*	*-9%*	*-40%*	*-27%*	*-23%*	*3%*	*-13%*	*32%*	*9%*	*5%*	*6%*
Operating income after tax[1]	$80,346	$93,455	$70,258	$78,225	$322,284	$83,208	$80,087	$77,942	$78,924	$320,160	$338,022
% change annual	*-17%*	*-8%*	*-28%*	*-14%*	*-17%*	*4%*	*-14%*	*11%*	*1%*	*-1%*	*6%*
Operating earnings per share	**$0.69**	**$0.81**	**$0.61**	**$0.69**	**$2.79**	**$0.73**	**$0.70**	**$0.68**	**$0.69**	**$2.80**	**$2.95**
% change annual	*-17%*	*-6%*	*-28%*	*-11%*	*-16%*	*6%*	*-13%*	*12%*	*0%*	*0%*	*5%*
Average diluted shares	116,372	116,075	115,418	114,111	115,494	113,300	114,350	114,500	114,600	114,188	114,500
Return on equity - operating basis	**13.0%**	**14.7%**	**10.8%**	**11.9%**	**12.6%**	**12.5%**	**11.7%**	**11.0%**	**10.9%**	**11.5%**	**10.9%**

[1]Income before net realized capital gains/losses and excluding discontinued operations.
Source: Company reports and William Blair & Company L.L.C. estimates

William Blair & Company, L.L.C. is a market maker in the security of HCC Insurance Holdings, Inc. and may have a long or short position.

Additional information is available upon request.



Current Rating Distribution (as of 04/30/09)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	57	Outperform (Buy)	3
Market Perform (Hold)	42	Market Perform (Hold)	1
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.

Mark Lane attests that 1) all of the views expressed in this research report accurately reflect his/her personal views about any and all of the securities and companies covered by this report, and 2) no part of his/her compensation was, is, or will be related, directly or indirectly, to the specific recommendations or views expressed by him/her in this report.

Stock Rating: William Blair & Company, L.L.C. uses a three-point system to rate stocks. Individual ratings reflect the expected performance of the stock relative to the broader market over the next 12 months. The assessment of expected performance is a function of near-term company fundamentals, industry outlook, confidence in earnings estimates, valuation, and other factors. Outperform (O) – stock expected to outperform the broader market over the next 12 months; Market Perform (M) – stock expected to perform approximately in line with the broader market over the next 12 months; Underperform (U) – stock expected to underperform the broader market over the next 12 months; Not Rated (NR) – the stock is currently not rated.

Company Profile: The William Blair research philosophy is focused on quality growth companies. Growth companies by their nature tend to be more volatile than the overall stock market. Company profile is a fundamental assessment, over a longer-term horizon, of the business risk of the company relative to the broader William Blair universe. Factors assessed include: 1) durability and strength of franchise (management strength and track record, market leadership, distinctive capabilities); 2) financial profile (earnings growth rate/consistency, cash flow generation, return on investment, balance sheet, accounting); 3) other factors such as sector or industry conditions, economic environment, confidence in long-term growth prospects, etc. Established Growth (E) – Fundamental risk is lower relative to the broader William Blair universe; Core Growth (C) – Fundamental risk is approximately in line with the broader William Blair universe; Aggressive Growth (A) – Fundamental risk is higher relative to the broader William Blair universe.

The ratings and company profile assessments reflect the opinion of the individual analyst and are subject to change at any time.

The compensation of the research analyst is based on a variety of factors, including performance of his or her stock recommendations; contributions to all of the firm's departments, including asset management, corporate finance, institutional sales, and retail brokerage; firm profitability; and competitive factors.

Please contact us at 1-800-621-0687 or consult http://www.williamblair.com/pages/eqresearch_coverage.asp for all disclosures.

William Blair & Company®

Investment Banking ▪ Asset Management ▪ Equity Research ▪ Institutional & Private Brokerage ▪ Private Capital

William Blair & Company, L.L.C. 222 West Adams Street Chicago, Illinois 60606 312.236.1600 www.williamblair.com

CHICAGO BOSTON LONDON NEW YORK SAN FRANCISCO SHANGHAI TOKYO ZURICH