

# HCC Insurance Holdings, Inc.

## Second-Quarter Results Solid, EPS Upside Driven By a Number of Factors; Increasing Estimates

- Second-quarter operating EPS increased 3%, to \$0.82, compared with our \$0.70 estimate and consensus of \$0.70. The outperformance relative to our estimate was driven by several factors, including higher favorable loss reserve development, a lower accident-year loss ratio, lower noninsurance company expenses, higher net investment income, and higher other income.
- Net written premium declined 4%, to \$543 million, compared with our flat growth estimate. Production in the quarter was driven by growth within the company's London market account, specifically within energy, and its diversified financial products line—which includes directors' and officers' liability (D&O) coverage—an area of the market that has shown the greatest rate increase to date. Net written premiums within the company's D&O product line increased 14% year-over-year and its other professional liability line increased 20%. Pricing continues to stabilize, but we do not expect a sharper recovery until underlying profitability for the industry comes under more significant pressure.
- The combined ratio was 83.8%, compared with our 85.8% estimate—\$16 million of favorable loss reserve development subtracted 3.2 percentage points from the loss ratio (compared to \$4.7 million adverse development and a modest 0.9-percentage-point addition last quarter). The loss ratio was 58.3%, compared with our estimate of 60.5%—our estimate included \$7.5 million of favorable loss reserve development, a 1.4-percentage-point benefit to our loss ratio estimate. No detail was given regarding any D&O loss reserve movement, although the number of claims is rising only at a measured pace. The last few quarters the company has taken up current accident-year loss reserves within D&O, offsetting favorable development in earlier years. The expense ratio was 25.5%, compared with our 25.3% estimate.
- Realized investment gains totaled \$933,000, compared with \$58,000 of losses last quarter. The company also had \$2.6 million of other-than-temporary impairment losses in the quarter, of which only \$1.8 million flowed through earnings. Diluted book value per share increased 4.6% during the quarter, to \$24.97, given the recovery in credit markets—less so than some of its peers because its investment portfolio is less risky.
- We are increasing our 2009 EPS estimate to \$2.97 from \$2.80 given the outperformance this quarter and higher underwriting profitability due to a favorable product mix shift. We are increasing our 2010 EPS estimate to \$3.10 from \$2.95 given higher underwriting profitability due to a favorable product mix shift.

### Financial | Commercial P/C Insurance

August 05, 2009

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

Symbol: HCC (NYSE)  
Price: \$25.44 (52-Wk.: \$14-\$30)  
Market Value (mil.): \$2,869  
Fiscal Year End: December  
Long-Term EPS Growth Rate: 15%  
Dividend/Yield: \$0.51/2.0%

	2008A	2009E	2010E
<b>Estimates</b>			
EPS Q1	\$0.70	A\$0.73	NA
Q2	\$0.81	A\$0.82	NA
Q3	\$0.61	\$0.69	NA
Q4	\$0.69	\$0.73	NA
FY	\$2.80	\$2.97	\$3.10
CY		\$2.97	\$3.10

#### Valuation

FY P/E	9.1x	8.6x	8.2x
CY P/E		8.6x	8.2x

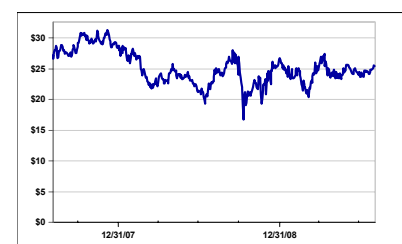
#### Trading Data (Thomson Financial)

Shares Outstanding (mil.)	112
Float (mil.)	112
Average Daily Volume	1,048,165

#### Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	12.6
Book Value Per Share (MRQ)	21.9
Enterprise Value (mil.)	3,061.4
EBITDA (TTM)	474.8
Enterprise Value/EBITDA (TTM)	6.4x
Return on Equity (TTM)	11.3

#### Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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- Our rating remains Market Perform, and we are reviewing estimates. 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 shares trade at roughly 1.02 times second quarter 2009 diluted book value per share of \$24.97, and while we view this as very attractive on an absolute basis, we see more relative value within the space.

### **EPS Upside Driven By a Number of Factors**

Second-quarter operating EPS increased 3%, to \$0.82, compared with our \$0.70 estimate and consensus of \$0.70. The outperformance relative to our estimate was driven by several factors, including higher favorable loss reserve development, a lower accident-year loss ratio, lower noninsurance company expenses, higher net investment income, and higher other income. Operating EPS exclude \$0.01 of realized investment losses. The operating ROE was a solid 13.4% in the second quarter and roughly 13.0% for the first half.

### **Premium Growth Under Some Pressure, Continued Growth in D&O**

Net written premium declined 4%, to \$543 million, compared with our flat growth estimate. Production in the quarter was driven by growth within the company's London market account, specifically within its energy business, which was up 13% year-over-year, and its diversified financial products line—which includes D&O 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 \$13.52), Hartford (HIG \$16.28), and XL Capital (XL \$14.78)—three major players in D&O. Net written premium declined 10%, to \$389 million, excluding energy, D&O, and other professional liability.

Net written premiums within diversified financial products overall increased 5%, to \$237 million—the company's D&O product line increased 14% year-over-year, and its other professional liability line increased 20%. 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 Group [CB \$48.56]). Life, accident, and health net written premium was down 1% in the quarter, to \$196 million (36% of total) given some pressure on exposure growth from the weak economy with pricing continuing to run modestly in excess of trend, according to management, which is unique within the broader industry. Aviation declined 19% in the quarter, to \$30 million, with improving conditions overall; the London Market Account (offshore energy, marine, and property) increased 6%, to \$54 million; and other specialty lines saw a reduction of 48% due to a sharp drop in the Lloyds 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 83.8%, compared with our 85.8% estimate—\$16 million of favorable loss reserve development subtracted 3.2 percentage points from the loss ratio (compared with \$4.7 million adverse development and a modest 0.9-percentage-point addition last quarter). The expense ratio was 25.5%, compared with our 25.3% estimate. The favorable development in the quarter was attributed to a reduction in reserves related to 2005 hurricane losses and related to 2001 through 2006

accident-year loss reserves within HCC's aviation and U.K. professional indemnity businesses. The loss ratio was 58.3%, compared with our estimate of 60.5%—our estimate included \$7.5 million of favorable loss reserve development, a 1.4-percentage-point benefit to our loss ratio estimate. Excluding favorable loss reserve development, the loss ratio was 61.5%, compared with our 61.9% estimate given minimal losses within the energy business and stronger growth in lower loss ratio businesses, including diversified financial products—51.0% loss ratio in first half 2009. D&O losses seem relatively well contained and there did not seem to be any movement of reserves by accident year that was experienced last year. The last few quarters the company has taken up current accident-year loss reserves within D&O, offsetting favorable development in earlier years. We expect continued favorable loss reserve development in 2009 with continued pressure on accident-year loss ratios by line of business in the aggregate.

#### **Realized Investment Losses Minimal, Capital Not an Issue**

Realized investment gains totaled \$933,000, compared with \$58,000 of losses last quarter. The company also had \$2.6 million of other-than-temporary impairment losses in the quarter, of which only \$1.8 million flowed through earnings. We would not be surprised by 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. Diluted book value per share increased 4.6% during the quarter, to \$24.97, given the recovery in credit markets—less so than some of its peers because its investment portfolio is less risky. HCC is one of the few companies in the space that continued to buy back stock during market weakness early in the year given its high financial flexibility, repurchasing \$35 million of stock in the first quarter. 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.

#### **Increasing Estimates, Rating Remains Market Perform—Quality Franchise, but See Better Value Within Space**

We are increasing our 2009 EPS estimate to \$2.97 from \$2.80 given the outperformance this quarter and higher underwriting profitability due to a favorable product mix shift. We are increasing our 2010 EPS estimate to \$3.10 from \$2.95 given higher underwriting profitability due to a favorable product mix shift. Our new 2009 EPS estimate is at the top end of management's adjusted guidance range. Management's unadjusted EPS guidance range remains \$2.65 to \$2.85 with no anticipated benefits from favorable loss reserve development—we estimate the benefit in the first half from favorable development was \$0.07 and we have an additional \$0.09 in the second half from favorable development and a \$0.04 catastrophe load in the third quarter. Management's guidance was based upon gross written premium of \$2.5 billion, flat from 2008 levels; net written premium of \$2.1 billion, flat from 2008 levels; a combined ratio of 86.5% (compared to 85.4% in 2008); and does not include a catastrophe loss provision; catastrophe losses totaled \$22.5 million in 2008. The combined ratio in first half 2009 excluding loss reserve development was 86.1%.

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 shares trade at roughly 1.04 times second quarter 2009 diluted book value per share of \$24.97, and while we view this as very attractive on an absolute basis, we see more relative value within the space. 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 for the group as limiting any downside.

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

	1Q08	2Q08	3Q08	4Q08	2008 Actual	1Q09	2Q09	3Q09E	4Q09E	2009 Estimate	2010 Estimate
<b>Gross written premium</b>	<b>\$582,999</b>	<b>\$691,593</b>	<b>\$612,964</b>	<b>\$611,207</b>	<b>\$2,498,763</b>	<b>\$602,387</b>	<b>\$681,317</b>	<b>\$631,451</b>	<b>\$645,193</b>	<b>\$2,560,348</b>	<b>\$2,756,455</b>
% change annual	-3%	4%	3%	3%	2%	3%	-1%	3%	6%	2%	8%
<b>Net written premium</b>	<b>\$493,647</b>	<b>\$567,150</b>	<b>\$495,585</b>	<b>\$504,236</b>	<b>\$2,060,618</b>	<b>\$491,250</b>	<b>\$543,352</b>	<b>\$518,867</b>	<b>\$534,357</b>	<b>\$2,087,826</b>	<b>\$2,254,519</b>
% change annual	-1%	6%	6%	4%	4%	0%	-4%	5%	6%	1%	8%
% gross written premium	85%	82%	81%	82%	82%	82%	80%	82%	83%	82%	82%
Premiums earned	\$493,546	\$506,610	\$504,972	\$502,646	\$2,007,774	\$502,388	\$501,978	\$504,016	\$505,691	\$2,014,073	\$2,121,173
% change annual	-1%	2%	2%	0%	1%	2%	-1%	0%	1%	0%	5%
Losses and LAE incurred	\$293,026	\$302,901	\$324,506	\$291,440	\$1,211,873	\$315,566	\$292,570	\$311,482	\$304,932	\$1,224,550	\$1,272,704
% premiums earned	59.4%	59.8%	64.3%	58.0%	60.4%	62.8%	58.3%	61.8%	60.3%	60.8%	60.0%
Favorable/(unfavorable) reserve development	\$5,100	\$9,300	\$44,000	\$24,000	\$82,400	(\$4,700)	\$16,000	\$7,500	\$7,500	\$26,300	\$15,000
% premiums earned	1.0%	1.8%	8.7%	4.8%	4.1%	-0.9%	3.2%	1.5%	1.5%	1.3%	0.7%
Policy acquisition costs	\$92,268	\$95,845	\$96,582	\$96,746	\$381,441	\$88,692	\$90,248	\$93,243	\$93,553	\$365,736	\$386,053
% premiums earned	18.7%	18.9%	19.1%	19.2%	19.0%	17.7%	18.0%	18.5%	18.5%	18.2%	18.2%
Underwriting expense	\$59,204	\$57,514	\$57,702	\$59,089	\$233,509	\$68,998	\$61,526	\$61,511	\$58,353	\$250,388	\$256,225
% of operating revenue less NII	11.4%	10.5%	10.5%	11.2%	10.9%	12.4%	11.5%	11.5%	11.0%	11.6%	11.4%
Expense ratio	24.3%	24.3%	23.7%	27.6%	25.0%	24.5%	24.3%	25.0%	24.7%	24.6%	24.7%
<b>Underwriting income</b>	<b>\$49,048</b>	<b>\$50,350</b>	<b>\$26,182</b>	<b>\$55,371</b>	<b>\$180,951</b>	<b>\$29,132</b>	<b>\$57,634</b>	<b>\$37,780</b>	<b>\$48,854</b>	<b>\$173,400</b>	<b>\$206,191</b>
% change annual	-3%	-4%	-56%	81%	-6%	-41%	14%	44%	-12%	-4%	19%
Underwriting margin	23.7%	23.1%	17.9%	19.8%	21.1%	19.9%	24.7%	20.9%	22.6%	22.0%	22.5%
<b>Combined ratio</b>	<b>83.7%</b>	<b>84.1%</b>	<b>88.0%</b>	<b>85.6%</b>	<b>85.3%</b>	<b>87.3%</b>	<b>82.6%</b>	<b>86.8%</b>	<b>85.0%</b>	<b>85.4%</b>	<b>84.7%</b>
Fees and commissions	\$30,999	\$30,764	\$37,795	\$25,643	\$125,201	\$30,294	\$26,132	\$26,457	\$23,079	\$105,961	\$105,961
% change annual	-4%	-1%	-12%	-25%	-11%	-2%	-15%	-30%	-10%	-15%	0%
Noninsurance company expenses	\$31,540	\$30,253	\$34,606	\$17,105	\$113,503	\$34,605	\$29,793	\$28,750	\$27,000	\$120,148	\$117,500
% change annual	8%	11%	-1%	-61%	-16%	10%	-2%	-17%	58%	6%	-2%
Fee-based income	(\$541)	\$511	\$3,189	\$8,538	\$11,698	(\$4,311)	(\$3,661)	(\$2,294)	(\$3,921)	(\$14,187)	(\$11,539)
% change annual	-119%	-87%	-59%	-184%	167%	696%	-816%	-172%	-146%	-221%	-19%
Fee-based margin	-2.1%	1.2%	7.5%	34.9%	8.7%	-8.1%	-11.6%	-7.8%	-15.0%	-10.1%	-9.6%
Net investment income	\$47,621	\$47,249	\$35,962	\$33,919	\$164,751	\$45,218	\$48,411	\$48,988	\$49,596	\$192,213	\$198,930
% change annual	-4%	-3%	-28%	-42%	-20%	-5%	2%	36%	46%	17%	3%
Other income	(\$4,946)	\$10,947	\$4,828	(\$1,191)	\$9,638	\$22,896	\$5,523	\$3,000	\$3,000	\$34,419	\$14,750
<b>Total operating revenues</b>	<b>\$567,220</b>	<b>\$595,570</b>	<b>\$583,557</b>	<b>\$561,017</b>	<b>\$2,307,364</b>	<b>\$600,796</b>	<b>\$582,044</b>	<b>\$582,460</b>	<b>\$581,366</b>	<b>\$2,346,667</b>	<b>\$2,440,814</b>
% change annual	-5%	0%	0%	-7%	-3%	6%	-2%	0%	4%	2%	4%
Pretax operating margin	21.0%	22.3%	14.4%	17.8%	18.9%	20.4%	22.9%	19.3%	20.8%	20.9%	20.8%
Interest expense	\$3,959	\$4,826	\$3,750	\$4,771	\$17,306	\$4,639	\$3,628	\$3,650	\$3,650	\$15,567	\$18,000
Income before income taxes	\$118,931	\$132,764	\$83,779	\$99,820	\$435,294	\$122,843	\$133,164	\$112,575	\$120,879	\$489,460	\$507,832
Provision for income taxes	\$37,482	\$41,089	\$24,726	\$27,543	\$130,840	\$39,673	\$41,579	\$35,461	\$38,077	\$154,790	\$157,428
Effective tax rate	31.5%	30.9%	29.5%	27.6%	30.1%	32.3%	31.2%	31.5%	31.5%	31.6%	31.0%
Net income	\$81,449	\$91,675	\$59,053	\$72,277	\$304,454	\$83,170	\$91,585	\$77,114	\$82,802	\$334,671	\$350,404
% change annual	-16%	-9%	-40%	-27%	-23%	2%	0%	31%	15%	10%	5%
Operating income after tax <sup>1</sup>	\$81,340	\$92,793	\$70,258	\$78,225	\$322,616	\$83,208	\$92,175	\$77,114	\$82,802	\$335,298	\$350,404
% change annual	-16%	-8%	-28%	-14%	-17%	2%	-1%	10%	6%	4%	5%
<b>Operating earnings per share</b>	<b>\$0.70</b>	<b>\$0.80</b>	<b>\$0.61</b>	<b>\$0.69</b>	<b>\$2.79</b>	<b>\$0.73</b>	<b>\$0.82</b>	<b>\$0.69</b>	<b>\$0.73</b>	<b>\$2.97</b>	<b>\$3.10</b>
% change annual	-16%	-7%	-28%	-11%	-15%	5%	2%	13%	7%	6%	4%
Average diluted shares	116,372	116,075	115,418	114,111	115,494	113,300	112,500	112,500	112,750	112,763	113,000
<b>Return on equity - operating basis</b>	<b>13.1%</b>	<b>14.6%</b>	<b>10.8%</b>	<b>11.9%</b>	<b>12.6%</b>	<b>12.5%</b>	<b>13.4%</b>	<b>10.8%</b>	<b>11.3%</b>	<b>12.0%</b>	<b>11.1%</b>

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

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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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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.

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