

# XL Capital Ltd.

## Moody's Reviews for Possible Downgrade, Company Should Have Some Options

### Highlights

> After the market close on October 23, Moody's Investors Service placed the Baa1 senior debt rating of XL Capital and the A1 insurance financial strength ratings of XL's insurance operating subsidiaries on review for possible downgrade. This decision is not an enormous surprise given continued financial market deterioration over the past few weeks, but it is disappointing and we did not expect Moody's to take a much a different view than S&P in the very near term. XL will need a plan to help keep its current rating or mitigate the degree of downgrade in order to maintain the insurance financial strength rating of its core underwriting companies in the A category. That said, even a downgrade within the A category is likely to be seen negatively, given waning confidence in the stability of XL's rating at any level, which probably requires XL to take more aggressive action. A rating in the A category is important for the company's reinsurance business (34% of net property-casualty premiums written in 2007) and the long tail liability portion of its insurance business (D&O/E&O liability, excess casualty, etc.), which constitutes approximately 50% of its insurance business and is similar in size to its reinsurance business. In any scenario, the announcement does not help XL competitively as we move into the critical January 1 renewal season.

> Moody's had not commented on XL's preannounced third-quarter earnings results on October 14. On October 10, at the time of the original preannouncement with limited details, S&P affirmed XL Capital's A-counterparty credit rating and the A+ counterparty credit and financial strength ratings on XL's core operating insurance subsidiaries—also maintaining the outlook at negative. Moody's stated that XL could be downgraded if future profitability is judged to be weaker than other A1 rated peers, realized losses are expected to be significant (e.g., other than temporary impairment losses in excess of \$500 million), and franchise value and financial flexibility remain under pressure. The latter concern should be assured by this announcement and limiting other than temporary impairment losses to less than \$500 million could also be a challenge (a range of \$250 million to \$275 million was prereleased for the third quarter). Moody's did not comment on when it expects to complete this review process (we expect prior to year-end) and what sort of movement would occur if the review developed adversely, but XL cannot afford to get to that point, in our opinion.

### Financial | Insurance

October 23, 2008

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

Symbol: XL (NYSE)  
Price: \$8.28 (52-Wk.: \$3-\$76)  
Market Value (mil.): \$3,332  
Fiscal Year End: December  
Long-Term EPS Growth Rate: 16%  
Dividend/Yield: \$1.11/13.4%

	2007A	2008E	2009E
<b>Estimates</b>			
EPS FY	\$9.72	\$4.28	\$3.25
CY		\$4.28	\$3.25
<b>Valuation</b>			
FY P/E	0.9x	1.9x	2.5x
CY P/E		1.9x	2.5x

### Trading Data (Thomson Financial)

Shares Outstanding (mil.)	312
Float (mil.)	NA
Average Daily Volume	9,798,461

### Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	NA
Book Value Per Share (MRQ)	NA
Enterprise Value (mil.)	3,332.4
EBITDA (TTM)	NA
Enterprise Value/EBITDA (TTM)	NA
Return on Equity (TTM)	NA

### Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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> We believe XL would have some options to deal with this issue and create value for shareholders, including raising private capital, receiving a strategic investment, or pursuing a reinsurance transaction—all would be very expensive, but probably available. The entire company could also be sold. We assume the capital requirement would be in the \$1 billion range if necessary. XL is pursuing strategic alternatives for its life reinsurance business, which could include a sale, although that option is probably not sufficient in the current market environment, in our opinion. Management has appeared confident that the company would not need to raise any capital to deal with elevated investment losses, given its capital issuance in August, the actions it has taken to reduce the risk within the investment portfolio, and strong internal capital generation. However, Moody's appears to have come to a different conclusion.

> Our rating remains Outperform and we continue to view the risk/reward as attractive. We believe XL can deal with the Moody's ratings issue, or create value for current shareholders from current valuation levels given its franchise right now—although the current market environment creates more execution than in a typical scenario. The shares trade at about 40% of GAAP book value (about \$21 per share) and about 27% of GAAP book value excluding accumulated other comprehensive income (AOCI). While we do not believe this type of action is imminent, \$1 billion of additional equity at \$5 per share takes GAAP book value to about \$15 per share. While we continue to remain cautious on the property-casualty insurance space given underlying deterioration in profitability, XL Capital is too inexpensive to ignore given its franchise and the more aggressive actions we expect that will continued to be taken to improve the company's risk profile.

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

Additional information is available upon request.



**Current Rating Distribution (as of 09/30/08)**

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	60	Outperform (Buy)	5
Market Perform (Hold)	39	Market Perform (Hold)	2
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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