

ACE Limited

Quality Third-Quarter Results; Pricing Trends Less Favorable, Pressure on Underlying Margins

- Third-quarter operating EPS increased 38%, to \$2.07, \$0.02 above our estimate and \$0.10 ahead of consensus. The outperformance relative to our estimate was principally driven by greater-than-expected favorable loss reserve development. We increased our estimate significantly after the end of the quarter following a modest quarter for catastrophe losses. While results have exceeded expectations this year given favorable loss reserve development and lower catastrophe losses, earnings have been well below management's original guidance this year excluding these factors.
- Net property-casualty written premiums decreased 5%, below our 2% growth estimate, but were flat on a constant-currency basis. Management stated that the company chose to forgo select growth opportunities in favor of better pricing, achieving an aggregate positive rate change of 2% during the third quarter. Recessionary pressures and heightened competitive pressures continue to serve as significant headwinds for the company. Price increases have not developed as strongly as expected year-to-date given continued economic weakness and less pressure on capital following a recovery in credit and equity markets. We believe earnings results for the overall industry need to deteriorate more meaningfully before prices move appreciably higher.
- Favorable loss reserve development continues to drive strong underwriting margins, while the accident-year loss ratio increased compared with last quarter. The combined ratio excluding the life insurance segment was 88.2%, compared with 98.0% in third quarter 2008 (elevated given above-average catastrophe losses) and slightly below our estimate of 88.5%. Favorable loss reserve development reduced the combined ratio by 6.7 percentage points this quarter, compared with 5.4 percentage points last quarter, and more than offset a higher accident-year loss ratio. We believe favorable loss reserve development is likely to continue over the next few quarters at a minimum, albeit at a more measured pace.
- The investment portfolio incurred net realized/unrealized investment gains of \$1.46 billion, up from a \$1.04 billion gain last quarter. GAAP book value per share increased 13.1% sequentially given the rally in credit spreads, compared with a 12.4% increase last quarter. GAAP book value per share excluding other comprehensive income increased only 2% sequentially, as realized losses remain elevated.

Financial | Commercial P/C Insurance

October 29, 2009

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

Symbol: ACE (NYSE)
Price: \$51.91 (52-Wk.: \$31-\$59)
Market Value (mil.): \$18,408
Fiscal Year End: December
Long-Term EPS Growth Rate: 14%
Dividend/Yield: \$1.14/2.2%

	2008A	2009E	2010E
Estimates			
EPS FY	\$7.72	\$8.12	\$7.60
CY		\$8.12	\$7.60
Valuation			
FY P/E	6.7x	6.4x	6.8x
CY P/E		6.4x	6.8x

Trading Data (Thomson Financial)

Shares Outstanding (mil.)	336
Float (mil.)	NA
Average Daily Volume	1,619,528

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	19.9
Book Value Per Share (MRQ)	49.5
Enterprise Value (mil.)	20,643.1
EBITDA (TTM)	2,095.0
Enterprise Value/EBITDA (TTM)	9.9x
Return on Equity (TTM)	7.1

Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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- Our rating remains Outperform. We are lowering our 2009 EPS estimate to \$8.12 from \$8.19 and our 2010 EPS estimate to \$7.60 from \$7.90, given continued pressure on pricing. We expect management to provide 2010 guidance late this year or early next year, as has been the case in years past, and we expect management to be more conservative than the aggressive guidance it provided for 2009. We remain selective in the space given what we view as an imminent deterioration in industrywide profitability. However, we believe investors should have some exposure to the group given near-trough valuation levels. We believe ACE should be core in the space, and it is defensive among financial services companies.

Overall Solid, EPS Upside Once Again Driven by Favorable Development

ACE's third-quarter operating income per share increased 38%, to \$2.07 (excluding net realized investment gains/losses), compared with our estimate of \$2.05 and consensus estimate of \$1.97. The outperformance relative to our estimate was principally driven by greater-than-expected favorable loss reserve development (reduction in loss estimates from prior years) during the quarter (roughly \$0.27 per share benefit relative to our estimate), offset by a higher loss ratio excluding favorable loss reserve development (accident-year loss ratio), which limited upside relative to our estimate. We increased our estimate significantly after the end of the quarter following a modest quarter for catastrophe losses. GAAP EPS including realized investment losses were \$1.46 for the quarter, compared with \$0.16 in third quarter 2008 and \$1.59 last quarter. Realized investment losses exceeded our estimate and remain elevated, driven by mark-to-market losses on derivatives including certain equity market hedges. ACE's operating return on equity (ROE) in the quarter was a strong 15.9%, compared with 12.7% in third quarter 2008 and 18.1% last quarter.

Pricing Environment Grinding Toward Stabilization; Economic Pressure Remains Key Headwind

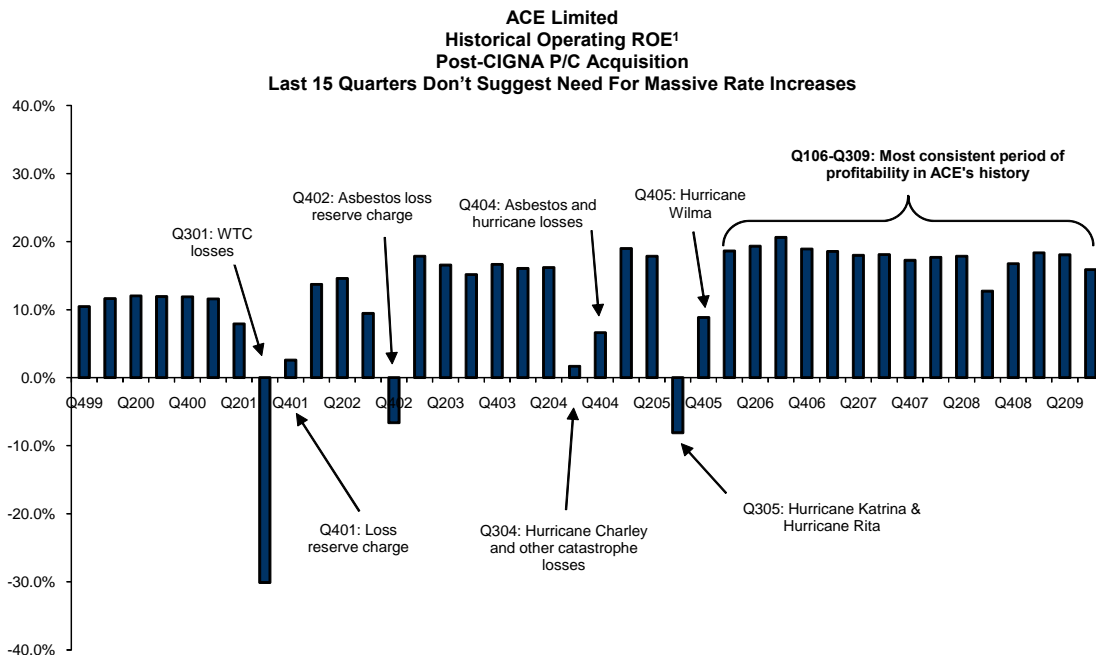
Net property-casualty written premiums decreased 5%, below our 2% growth estimate. Foreign-exchange translations adversely affected growth by roughly 5 percentage points, but this was largely included with our estimate. The retention rate in third quarter 2008 (net written premiums as a percentage of gross written premiums) was unusually low, which was why our estimate was positive. Gross written premiums declined 4.5%, compared with our 2% decline estimate. As expected, the pricing environment was relatively static compared with second quarter, with modest stabilization during the quarter and rate increases highly variable across business lines. Pricing improvements continue to be led by reinsurance—most pronounced within property and catastrophe lines—although insurance prices were up globally at ACE for the third consecutive quarter, albeit modestly. Overall, management estimated that for its P&C business globally, the recession has had a 4- to 5-percentage-point adverse impact on its premium growth this quarter. That said, ACE continues to take share in lines of business for which financial strength is more important and customers are less price sensitive, capitalizing on opportunities in the market where prices have risen in response to underwriting losses or heightened risk concerns—financial institution professional liability, political risk, trade credit risk, offshore and onshore energy, property catastrophe, and aviation. We believe that growth will improve in the fourth quarter on a constant-currency basis, even if only modestly. Management was also optimistic regarding growth in the fourth quarter given its robust pipeline, which includes some large transactions, coupled with an anticipated positive impact from a weakening U.S. dollar.

The company's global P&C reinsurance business (only 7.4% of P&C net written premiums) increased 18.4% in the quarter, marking the third quarter of positive growth and the second quarter of double-digit positive growth in this business since second quarter 2006. Strong growth was attributed to a combination of an improvement in pricing, market share gains, and higher demand from companies continuing to seek capital relief through the additional purchase of reinsurance. Management stated that catastrophe pricing stayed constant compared with last quarter, with U.S. reinsurance catastrophe rates up 10% and international reinsurance catastrophe rates up 5%. Casualty-related reinsurance business for the United States and international was flat to up slightly, also consistent with last quarter.

On the insurance side, the global P&C retail business grew 3.7%, while the London and wholesale segments experienced a 16% decline in growth, reflective of heightened competition in these markets. Management stated that overall rates in U.S. retail were up 3.5%, with renewal retention up from the year-ago period at 87.5%. The U.S. wholesale business continued to see a decline in retention, consistent with ACE's push for more adequate pricing, achieving a 7% rate increase for this portfolio overall (6% increase for casualty and 8.5% increase for property), according to management.

Management stated that U.S. casualty wholesale business (E&S) has shrunk from its peak of about \$600 million to currently \$50 million, highlighting the level of competition in this segment and ACE's willingness to move aggressively out of certain markets if returns are not adequate.

Regarding pricing improvements, management stated that a genuine transition to a lasting hard market is generally driven by balance sheet deterioration as opposed to income statement deterioration, and balance sheets are in good shape with the recovery in credit and equity markets. However, we generally disagree with this posture, and it is our view that outside a shock loss it is the income statement that ultimately drives the balance sheet and underwriters ultimately react to deterioration in underwriting profitability. Importantly, we still view loss reserves as too redundant and perceived underlying profitability as too high for aggressive price increases at this point in the cycle, especially with the added drag of a weak global economy. Despite economic and competitive headwinds, the industry is not that far away from generating record underwriting margins and ACE itself has been generating above-average results over the past several quarters. The last 15 quarters have been the most consistently profitable period in ACE's history, with the company generating a 15.9% operating ROE in third quarter 2009 on top of nearly five years of price declines. These conditions are not anywhere near those expected during a major pricing turn, in our opinion.



¹ROE excluding net realized investment gains/losses.
Source: Company reports and William Blair & Company research

Favorable Loss Reserve Development Continues to Benefit Underwriting Margins

The combined ratio excluding the life insurance segment was 88.2%, 86.7% excluding catastrophe losses, and 93.4% excluding catastrophe losses and favorable loss reserve development—compared with 87.8%, 86.7%, and 92.1% last quarter, respectively, and 98.0%, 85.4%, and 93.9% in third quarter 2008, respectively. The favorable development recognized this quarter was \$203 million pretax, compared with our estimate of \$90 million and \$158 million last quarter. Roughly two-thirds of the favorable development was from accident-years 2004 and prior, with the balance from accident-year 2005, largely within casualty lines—the first time we believe ACE has recognized meaningful favorable development on the casualty side. We believe favorable loss reserve development is likely to continue over the next few quarters, at a minimum, as the 2004 to 2006 accident years develop favorably, since there appears to be no serious signs of claims inflation concern at this time—although the topic has been the source of discussion of late. The accident-year loss ratio excluding catastrophe losses was higher in third quarter 2009 compared with second quarter (63.4% compared with 62.5%), although it is impossible for us to analyze from the outside what contributed exactly to this increase and could be product mix driven. The accident-year loss ratio for the first nine months was about 62.2%, even with 62.2% for all of 2008. We forecast roughly a stable accident-year loss ratio excluding

catastrophe losses in 2009 on consistent product basis. Expenses also continue to be well managed despite pressure on premium growth—the expense ratio within property-casualty in third quarter 2009 was 28.8%, compared with 27.6% in third quarter 2008, 28.3% last quarter, and our estimate of 27.8%.

Capital Position Remains Strong

The investment portfolio incurred net realized/unrealized investment gains of roughly \$1.46 billion (\$3.57 per share), compared with a \$1.04 billion gain (\$2.55 per share) last quarter. Net unrealized pretax gains in the quarter were roughly \$1.6 billion, partly offset by net realized losses during the quarter of \$164 million, compared with \$179 million last quarter and about \$1.4 billion for all of 2008. GAAP book value per share increased 13.1% sequentially given the rally in credit spreads, while GAAP book value per share excluding other comprehensive income increased 2% sequentially. This benefit was partly offset by a roughly \$130 million loss related to a fair value increase of the company's GMB (guaranteed minimum income benefit) liability within its life segment related to an improvement in the company's own credit spreads, and a \$40 million reduction in book value related to ACE's investment in Assured Guaranty (AGO \$17.00). Due to Assured's recent equity raise diluting ACE's ownership from 21% to roughly 12%, ACE will move away from the equity method of accounting to a marking of its position to market.

Management took more a defensive stance during late 2008/early 2009, substantially increasing its allocation to cash within its investment portfolio. During the second quarter, as equity markets and several sectors of the credit markets began to stabilize, management redeployed \$1.8 billion of its cash position and reallocated another \$800 million of equities, adding \$350 million in high-grade mortgages, \$400 million of treasuries, \$600 million of corporate bonds, \$250 million of agencies, and approximately \$1 billion of high-yield investments. This quarter, management invested roughly \$500 million in high-grade corporate bonds, and invested roughly \$100 million into high-yield bonds, stating that it does not anticipate the need for additional tactical adjustments to the portfolio in the near term. While below-investment-grade exposures increased roughly \$1.1 billion in the quarter (compared with an increase of roughly \$1.6 billion last quarter), this once again was principally a function of positions that were added to the portfolio in the quarter and appreciation of existing positions as opposed to negative ratings migration. The portfolio remains relatively well positioned, in our view, with limited structured credit, limited private equity, highly rated CMBS, and limited concentration risk. The company also has minimal exposure to preferred securities of financial institutions globally. As of September 30, 2009, 29% of the total \$43.9 billion fixed-income portfolio (market value) was U.S. corporate bonds and the vast majority of the investment portfolio's 11% below-investment-grade exposure was U.S. corporate debt. The MBS portfolio (26% of total) was \$7.6 billion agencies, \$643 million triple-A non-agency RMBS with minimal subprime, and \$1.9 billion triple-A CMBS. The only other area of concern is \$4.7 billion of non-U.S. government exposure, for which the disclosure is inadequate, although it shows \$3.2 billion AAA exposure and only \$40 million below-investment-grade exposure.

Management believes the company remains well capitalized with minimal debt refinancing needs over the next five years. Total debt to total capitalization was only 15.6% as of September 30, 2009, and could move higher at the current ratings even on a temporary basis—up to 30%—which would imply debt capacity of more than \$4.0 billion.

Rating Remains Outperform, Risk Profile Remains Attractive in This Environment Despite Underlying Pressures

We are lowering our 2009 EPS estimate to \$8.12 from \$8.19 and our 2010 EPS estimate to \$7.60 from \$7.90. We expect management to provide 2010 guidance late this year or early next year, as has been the case in years past. While results have exceeded expectations this year given favorable loss reserve development and lower catastrophe losses, earnings have been well below management's original guidance this year excluding these factors. Management's original operating EPS guidance range for 2009 was \$8.25 to \$9.25 excluding catastrophe losses and any loss reserve development—versus our current estimate of \$7.22 on a similar basis. We expect management to provide 2010 guidance late this year or early next year, as has been the case in years past, and we expect management to be more conservative than the aggressive guidance it provided for 2009. Our 2010 EPS estimate includes \$0.97 per share of catastrophe losses, versus \$0.38 per share in 2009—the former similar to the amount of catastrophe losses included in management's original 2009 guidance

and what we expect will be included in management's guidance for 2010. Our 2010 EPS estimate includes \$0.63 per share of favorable loss reserve development, versus \$1.29 per share in 2009. Management's guidance does not include favorable loss reserve development and therefore we expect our estimate to be above management's guidance or at the higher end of its guidance range. Our 2010 estimate includes slightly lower accident-year loss ratios excluding catastrophe losses, which could prove aggressive with the exception of the reinsurance segment, which has seen healthy price increases this year in the aggregate.

We remain selective in the space given what we view as an imminent deterioration in industrywide profitability. However, we believe investors should definitely have some exposure to the group given near-trough valuation levels. We believe ACE should be core in the space, and it is defensive among financial services companies, with limited credit exposure and no business model risk. We view ACE as undervalued on an absolute basis and we view an entry point below GAAP book value excluding other comprehensive income (\$53.04 as of September 30, 2009) as very attractive over any reasonable period. GAAP book value including other comprehensive income ended the quarter at \$55.36.

ACE Limited
Condensed Income Statement Comparison
(\$ in millions, except per share data)

	1Q08	2Q08	3Q08	4Q08	2008 Actual	1Q09	2Q09	3Q09	4Q09E	2009 Estimate	2010 Estimate
Property-Casualty Insurance											
Gross premiums written	\$4,304	\$4,866	\$4,839	\$3,906	\$17,915	\$4,150	\$4,733	\$4,622	\$3,996	\$17,501	\$18,205
% change annual	-2%	7%	11%	-3%	3%	-4%	-3%	-4%	2%	-2%	4%
Net premiums written	\$3,049	\$3,224	\$2,928	\$2,681	\$11,882	\$3,078	\$3,048	\$2,783	\$2,737	\$11,646	\$12,161
% change annual	-4%	8%	8%	-1%	2%	1%	-5%	-5%	2%	-2%	4%
% gross premiums written	70.8%	66.3%	60.5%	68.6%	66.3%	74.2%	64.4%	60.2%	68.5%	66.5%	66.8%
Net premiums earned	\$2,840	\$3,061	\$3,265	\$2,867	\$12,033	\$2,859	\$2,902	\$3,031	\$2,909	\$11,701	\$11,903
% change annual	-5%	5%	7%	-3%	1%	1%	-5%	-7%	1%	-3%	2%
Loss and loss expense	\$1,579	\$1,785	\$2,265	\$1,654	\$7,283	\$1,704	\$1,688	\$1,764	\$1,737	\$6,893	\$7,365
% premiums earned	55.6%	58.3%	69.4%	57.7%	60.5%	59.6%	58.2%	58.2%	59.7%	58.9%	61.9%
Adverse loss reserve development	(\$137)	(\$104)	(\$277)	(\$252)	(\$770)	(\$68)	(\$158)	(\$203)	(\$98)	(\$527)	(\$260)
Catastrophe losses	\$31	\$58	\$411	\$67	\$567	\$38	\$31	\$45	\$44	\$158	\$400
Loss ratio—ex cats and development	59.3%	59.8%	65.3%	64.1%	62.2%	60.7%	62.5%	63.4%	61.6%	62.1%	60.7%
Underwriting expense	\$783	\$864	\$901	\$796	\$3,344	\$763	\$820	\$873	\$814	\$3,270	\$3,362
% premiums earned	27.6%	28.2%	27.6%	27.8%	27.8%	26.7%	28.3%	28.8%	28.0%	27.9%	28.2%
Corporate administrative expense	\$39	\$39	\$33	\$42	\$153	\$35	\$39	\$35	\$38	\$147	\$150
% premiums earned	1.4%	1.3%	1.0%	1.5%	1.3%	1.2%	1.3%	1.2%	1.3%	1.3%	1.3%
Underwriting income	\$439	\$373	\$66	\$375	\$1,253	\$357	\$355	\$359	\$320	\$1,391	\$1,026
% change annual	15%	4%	-81%	7%	-13%	-18%	-4%	44%	-15%	11%	-26%
Combined ratio	84.5%	87.8%	98.0%	86.9%	89.6%	87.5%	87.8%	88.2%	89.0%	88.1%	91.4%
Net investment income—P/C	\$474	\$492	\$480	\$474	\$1,920	\$456	\$463	\$468	\$469	\$1,856	\$1,945
% change annual	8%	8%	0%	-3%	3%	-4%	-6%	-3%	-1%	-3%	5%
Pretax operating income	\$913	\$865	\$546	\$849	\$3,173	\$813	\$818	\$827	\$789	\$3,247	\$2,971
% change annual	11%	6%	-34%	1%	-4%	-11%	-5%	51%	-7%	2%	-8%
Life Insurance											
Pretax operating income	\$31	\$81	\$85	\$21	\$218	\$67	\$78	\$95	\$75	\$315	\$349
% change annual	-24%	84%	93%	-32%	36%	116%	-4%	12%	256%	44%	11%
Interest expense	\$46	\$62	\$68	\$54	\$230	\$53	\$56	\$60	\$54	\$223	\$215
Other income	\$13	\$5	\$17	(\$17)	\$18	(\$17)	\$13	(\$8)	\$3	(\$10)	\$10
Pretax income	\$911	\$889	\$580	\$799	\$3,179	\$810	\$853	\$854	\$812	\$3,329	\$3,115
% change annual	12%	8%	-30%	-4%	-4%	-11%	-4%	47%	2%	5%	-6%
% total revenue	26.6%	22.4%	14.0%	21.3%	20.8%	21.9%	22.6%	21.9%	21.3%	21.9%	20.0%
Income tax expense	\$186	\$151	\$76	\$175	\$588	\$141	\$147	\$153	\$146	\$587	\$539
Effective tax rate	20.4%	17.0%	13.1%	21.9%	18.5%	17.4%	17.2%	17.9%	18.0%	17.6%	17.3%
Income excluding realized gains	\$725	\$738	\$504	\$624	\$2,591	\$669	\$706	\$701	\$666	\$2,742	\$2,576
% change annual	9%	11%	-27%	-10%	-4%	-8%	-4%	39%	7%	6%	-6%
Net realized investment gains/(losses)	(\$348)	\$8	(\$450)	(\$604)	(\$1,394)	(\$102)	(\$171)	(\$207)	\$0	(\$480)	\$0
Net income	\$377	\$746	\$54	\$20	\$1,197	\$567	\$535	\$494	\$666	\$2,262	\$2,576
% change annual	-46%	15%	-92%	-97%	-54%	50%	-28%	81%	3229%	89%	14%
Preferred dividends	(\$11)	(\$13)	\$0	\$0	(\$24)	\$0	\$0	\$0	\$0	\$0	\$0
Operating income available to common shareholders ¹	\$714	\$725	\$504	\$624	\$2,567	\$669	\$706	\$701	\$666	\$2,742	\$2,576
% change annual	10%	11%	-26%	-8%	-4%	-6%	-3%	39%	7%	7%	-6%
Diluted operating EPS	\$2.16	\$2.18	\$1.50	\$1.87	\$7.71	\$1.99	\$2.09	\$2.07	\$1.97	\$8.12	\$7.60
% change annual	9%	10%	-27%	-9%	-5%	-8%	-4%	38%	5%	5%	-6%
Average diluted shares	331	333	335	333	333	336	338	338	339	338	339
Operating return on equity—diluted	17.7%	17.8%	12.7%	16.8%	16.3%	18.4%	18.1%	15.9%	14.0%	16.4%	12.7%
Book value per share—diluted	\$48.87	\$49.00	\$45.80	\$43.40	\$43.40	\$43.79	\$49.07	\$55.36	\$57.00	\$57.00	\$63.21

¹Excludes net realized investment gains/(losses).

Source: Company reports and William Blair & Company estimates

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

Additional information is available upon request.



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

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	63	Outperform (Buy)	2
Market Perform (Hold)	37	Market Perform (Hold)	0
Underperform (Sell)	0	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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