

AMERISAFE, Inc.

Third-Quarter Results: Outperformance Once Again Driven by Favorable Development, Underlying Pressure Continuing to Build

Highlights

- AMERISAFE's third-quarter operating EPS based on a fully converted share count decreased 10%, to \$0.67, compared with our \$0.59 estimate and consensus estimate of \$0.54. Upside relative to our estimate was principally driven by \$0.21 per share of favorable loss reserve development.
- Gross written premium decreased 27%, to \$55.1 million, meaningfully below our estimate of a decline of 8%, reflecting lower audit adjustments for policies written in prior periods and a decrease in premiums written during the quarter. The decline in growth this quarter was not a complete surprise given that the market remains competitive and recessionary pressures are mounting, particularly for workers' compensation insurers. The pricing environment in AMERISAFE's business remains soft and the company maintained its pricing discipline in the quarter, contributing to the decline in premium growth.
- The combined ratio was 79.3%, compared with our 84.8% estimate—favorable loss reserve development lowered the loss ratio by 11.5 percentage points. The expense ratio was 21.6%, modestly above our estimate of 20.6%, given pressure on top-line growth. The accident-year loss ratio (losses estimated on business written in 2009) was booked at 68.9% in the third quarter, compared with the total year accident-year 2008 loss ratio of 68.0%, and relatively in line with our estimate of 69.2%.
- Our rating remains Market Perform. We are increasing our 2009 EPS estimate to \$2.52 from \$2.40 given the outperformance this quarter and higher favorable development in the fourth quarter. Our 2010 EPS estimate remains \$2.10, with lower net investment and net earned offset by higher favorable loss reserve development.

Financial | Commercial P/C Insurance

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

Symbol: AMSF (NASDAQ)
Price: \$19.33 (52-Wk.: \$13-\$22)
Market Value (mil.): \$351
Fiscal Year End: December
Long-Term EPS Growth Rate: 12%
Dividend/Yield: None

	2008A	2009E	2010E
Estimates			
EPS Q1	\$0.59	A\$0.54	NA
Q2	\$0.63	A\$0.67	NA
Q3	\$0.75	A\$0.67	NA
Q4	\$0.94	\$0.64	NA
FY	\$2.90	\$2.52	\$2.10
CY		\$2.52	\$2.10

Valuation			
FY P/E	6.7x	7.7x	9.2x
CY P/E		7.7x	9.2x

Trading Data (Thomson Financial)

Shares Outstanding (mil.)	19
Float (mil.)	NA
Average Daily Volume	105,296

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	12.9
Book Value Per Share (MRQ)	11.6
Enterprise Value (mil.)	330.2
EBITDA (TTM)	70.6
Enterprise Value/EBITDA (TTM)	4.7x
Return on Equity (TTM)	15.1

Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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Discussion

Favorable Development Once Again Drives Outperformance

AMERISAFE's third-quarter operating EPS based on a fully converted share count decreased 9.7%, to \$0.67, compared with our \$0.59 estimate and consensus estimate of \$0.54. Upside relative to our estimate was principally driven by \$6.7 million (roughly \$0.21 per share) of favorable loss reserve development, compared with \$5.2 million (roughly \$0.17 per share) of favorable development last quarter. We included \$3.5 million (roughly \$0.11) of favorable loss reserve development in our estimate. AMERISAFE has exceeded the estimate every quarter since its IPO in late 2005 with the exception of first quarter 2009, when the company met expectations. Operating return on equity was a strong 17.7% in the quarter, down from 23.4% in the third quarter 2008, and the company realized \$2 million of investment gains in the quarter, resulting from the sale of equities and one asset-backed security that was impaired in the third and fourth quarters of 2008.

Decline in Gross Written Premium Not a Complete Surprise Given Business Line Profile— Pressure Likely to Be Extended

Gross written premium decreased 27%, to \$55.1 million, below our estimate of a decline of 8%, reflecting lower audit adjustments (\$7.8 million decline versus a \$1.9 million decline in third quarter 2008) for policies written in prior periods. Voluntary workers' compensation business written decreased 12% in the quarter, and there was a \$5.4 million reduction in the estimate for earned but unbilled premium (EBUB) during the quarter. The EBUB adjustment was established in fourth quarter 2006 to reflect changes in expected future premium from policy audits given expected payrolls, economic conditions, etc. This was by far the largest single quarter adjustment to this estimate reflective of the challenging market conditions and compared with a \$380,000 reduction in third quarter 2008. Management is taking action to combat the difficult growth environment by expanding into new geographies, targeting new hazardous classes in states that have been strong for the company, raising commission rates in select states, and executing a new maritime initiative. The decline in growth this quarter was not a complete surprise given that the market remains highly competitive coupled with mounting recessionary pressures, resulting in an amplified adverse impact given AMERISAFE's business mix. We expect growth to remain challenged in the fourth quarter. The pricing environment in AMERISAFE's business was relatively unchanged relative to the second quarter and management stated that competition for larger accounts remains elevated, although competition from AIG (AIG \$35.48) is not as aggressive as it was six to nine months ago. Our view has been that workers' compensation insurance would be among the last lines to see cyclical improvements, partly driven by heavy regulation of the business line. 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.

AMERISAFE enjoyed good new business growth from clients moving from AIG, the top market share holder for workers' compensation insurance for the past several years. In fourth quarter 2008, management began tracking new business earned from AIG, and from mid-September through the end of 2008 AMERISAFE booked 142 new accounts totaling roughly \$7.3 million in premium—average policy size was over \$50,000, compared with AMERISAFE's average policy size for the balance of the year at \$36,600. In first quarter 2009, AMERISAFE secured 88 policies totaling roughly \$4.0 million in premium—average policy size was roughly \$45,500, compared with AMERISAFE's average policy size in the quarter of \$36,300. In second quarter 2009, AMERISAFE secured roughly \$4.1 million in premium. Management indicated that this quarter, it has started to see a decline from business from AIG—accounting for a much smaller percentage of premium growth, given a rationalization of the concern previously present in the marketplace due to the increased level of the U.S. government in the management of AIG—and despite less aggressive pricing.

For the company's in-force business, insured payrolls decreased by 1.1% in the third quarter, compared with a decrease of 0.4% last quarter, while total in-force premium decreased 5.2% in the third quarter, compared with a decrease of 2.7% last quarter. Management stated the renewal

retentions by policy and premium have improved, which is a bit surprising to us given competitive pressure, although AMERISAFE's markets are more service intensive than many lines of insurance business. Management also indicated that its average policy size continues to decrease, consistent with lower payrolls and lower lost costs. The decrease in premium is consistent with the competitive environment and reflective of the soft pricing that has persisted over the past four years. In the renewal business, voluntary workers' compensation count retention was 92.5%, a slight increase from the year-ago period (92.2%) and an improvement compared with 91.7% last quarter; and premium retention was up by 7.6 percentage points over the year-ago period, compared with an 8.8-percentage-point increase last quarter and a 7-percentage-point increase in first quarter 2009.

Margins Remain Ahead of Expectations Given Benefit From Favorable Development, Underlying Profitability Likely to Come Under Pressure

The reported combined ratio was 79.3%, compared with our 84.8% estimate, and benefited from 11.5 percentage points (\$6.7 million) of favorable loss reserve development in the quarter. The combined ratio was 83.3% last quarter, and benefited from 7.9 percentage points (\$5.2 million) of favorable loss reserve development, and in third quarter 2008, the combined ratio was 79.4%, and benefited from 9.3 percentage points (\$6.6 million) of favorable reserve development. The favorable loss reserve development in the quarter was principally attributed to accident-year 2007. In its first two years as a public company (2006 and 2007), AMERISAFE only adjusted reserve from prior periods at the end of the year, but last year, given the degree of favorable development, management started recognizing favorable loss reserve development earlier in the year.

The loss ratio was 57.4% in the quarter, and the accident-year loss ratio (losses estimated on business written in 2009) was booked at 68.9% in the third quarter, relatively in line with our estimate of 69.2% and compared with 69.0% last quarter (61.1% including favorable reserve development), 58.9% in third quarter 2008 (58.9% including favorable reserve development), and 68.0% for all of 2008. Importantly, frequency of claims is declining on an earned premium basis as management attributes this to more experienced workers' employment being retained as well as higher safety standards being implemented by companies to reduce workers' compensation expense in general. That said, severity of losses has begun to increase due to increased medical costs, particularly prescription costs. Management stated that each of its claims adjustors is responsible for roughly fifty open claims compared with an industry average of 150 to 200 claims per adjustor. This enables close client contact and swift resolution of claims in an effort to improve client service and limit the loss potential of each claim, as there generally is a positive correlation between length of an open claim and the amount of loss that claim generates. The company's expense ratio was 21.6% in the quarter, modestly above our 20.6% estimate, given pressure on top-line growth. This is a reflection of the company's aggressive expense management, as well as the impact from AMERISAFE's 2009 \$5 million excess of \$5 million loss reinsurance treaty—through which the company locked in the vast majority of its reinsurance costs, a prudent decision in light of the current rising price environment for reinsurance. As long as the company does not penetrate the contract's \$20 million aggregate annual-rate deductible, the benefit will continue to offset expenses; once the deductible is reached, the benefit would transfer from the expense ratio to the loss ratio in the form of ceded losses. In the second quarter, the company received \$438,000 of commissions offsetting expenses, in line with commissions received last quarter. The 2009 treaty is a three-year treaty, scheduled to expire January 1, 2012.

The policyholder dividend ratio (premiums returned or credited to policyholders if certain levels of profitability are attained), which is the third component of the combined ratio, was 0.3%, essentially in line with third quarter 2008 and our estimate. The majority of dividends are paid to policyholders in Florida under a state-statutory formula.

Maintaining Market Perform Rating; Adjusting Estimates to Account for Outperformance and Enhanced Pressure on Premium Growth

We are increasing our 2009 EPS estimate to \$2.52 from \$2.40 given the outperformance this quarter and higher favorable development in the fourth quarter. Our 2010 EPS estimate remains \$2.10, with lower net investment and net earned offset by higher favorable loss reserve development. Fully diluted book value per share ended the quarter at \$15.66. The shares trade at 1.23 times diluted book, which is a moderate premium to the overall commercial lines underwriting group, although there is probably

not another publicly traded commercial underwriter that has matched AMERISAFE's financial performance relative to expectations over the past three years and the company remains well managed. 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. Regarding AMERISAFE, we remain concerned about the negative impact on payroll growth (main driver of premiums) from the weaker economy and the underlying deterioration in profitability that will eventually catch up with underlying claims inflation. In addition, we also believe that pricing within the workers' compensation insurance segment will be slower to turn than other areas within the market given heavier regulation of the business line.

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

	1Q08	2Q08	3Q08	4Q08	2008 Actual	1Q09	2Q09	3Q09	4Q09E	2009 Estimate	2010 Estimate
Gross premiums written	\$80,977	\$85,995	\$75,767	\$65,102	\$307,841	\$79,429	\$72,537	\$55,119	\$56,964	\$264,049	\$264,049
<i>% change annual</i>	-11%	-9%	-7%	5%	-6%	-2%	-16%	-27%	-13%	-14%	0%
Net premiums written	\$76,187	\$81,329	\$71,193	\$59,482	\$288,191	\$74,235	\$67,667	\$51,068	\$52,692	\$245,662	\$246,886
<i>% change annual</i>	-11%	-9%	-6%	5%	-6%	-3%	-17%	-28%	-11%	-15%	0%
<i>% gross premiums written</i>	94.1%	94.6%	94.0%	91.4%	93.6%	93.5%	93.3%	92.7%	92.5%	93.0%	93.5%
Net premiums earned	\$74,300	\$72,143	\$71,284	\$71,766	\$289,493	\$70,001	\$65,792	\$58,133	\$61,925	\$255,851	\$246,274
<i>% change annual</i>	-2%	-6%	-10%	-3%	-6%	-6%	-9%	-18%	-14%	-12%	-4%
Loss and loss expense	\$49,928	\$47,317	\$41,972	\$37,172	\$176,389	\$47,070	\$40,219	\$33,358	\$36,721	\$157,368	\$158,600
<i>% premiums earned</i>	67.2%	65.6%	58.9%	51.8%	60.9%	67.2%	61.1%	57.4%	59.3%	61.5%	64.4%
Reserve development	\$1,700	\$2,800	\$6,600	\$9,300	\$20,400	\$1,200	\$5,200	\$6,700	\$6,000	\$19,100	\$12,500
<i>% premiums earned</i>	2.3%	3.9%	9.3%	13.0%	7.0%	1.7%	7.9%	11.5%	9.7%	7.5%	5.1%
Total underwriting expenses	\$14,514	\$14,149	\$14,474	\$12,799	\$55,936	\$14,768	\$14,475	\$12,535	\$13,592	\$55,370	\$54,796
<i>Expense ratio</i>	19.5%	19.6%	20.3%	17.8%	19.3%	21.1%	22.0%	21.6%	22.0%	21.6%	22.3%
Policyholder dividends	\$316	\$122	\$125	\$2,941	\$3,504	\$181	\$141	\$201	\$124	\$647	\$493
<i>Policyholder dividend ratio</i>	0.4%	0.2%	0.2%	4.1%	1.2%	0.3%	0.2%	0.3%	0.2%	0.3%	0.2%
Underwriting income	\$9,542	\$10,555	\$14,713	\$18,854	\$53,664	\$7,982	\$10,957	\$12,039	\$11,487	\$42,465	\$32,385
<i>% change annual</i>	67%	18%	71%	-6%	24%	-16%	4%	-18%	-39%	-21%	-24%
<i>Combined ratio</i>	87.2%	85.4%	79.4%	73.7%	81.5%	88.6%	83.3%	79.3%	81.5%	83.4%	86.9%
Fees and other income	\$141	\$229	\$200	\$172	\$742	\$136	\$705	\$242	\$200	\$1,283	\$1,000
<i>% change annual</i>	1%	66%	-69%	23%	-30%	-4%	208%	21%	16%	73%	-22%
Net investment income	\$7,817	\$7,405	\$7,712	\$8,064	\$30,998	\$7,372	\$6,982	\$6,877	\$6,861	\$28,092	\$28,105
<i>% change annual</i>	13%	0%	-3%	2%	3%	-6%	-6%	-11%	-15%	-9%	0%
<i>% of average invested assets</i>	4.1%	3.8%	4.0%	4.1%	4.0%	3.7%	3.5%	3.4%	3.3%	3.5%	3.3%
Interest expense	\$769	\$657	\$654	\$380	\$2,460	\$611	\$383	\$417	\$425	\$1,836	\$1,800
Pretax operating income	\$16,731	\$17,532	\$21,971	\$26,710	\$82,944	\$14,879	\$18,261	\$18,741	\$18,123	\$70,004	\$59,690
<i>% change annual</i>	41%	12%	35%	-2%	17%	-11%	4%	-15%	-32%	-16%	-15%
Net realized investment gains/(losses)	\$8	\$53	(\$2,921)	(\$15,996)	(\$18,856)	\$26	\$17	\$1,956	\$0	\$1,999	\$0
Income before taxes	\$16,739	\$17,585	\$19,050	\$10,714	\$64,088	\$14,905	\$18,278	\$20,697	\$18,123	\$72,003	\$59,690
<i>% change annual</i>	41%	13%	17%	-61%	-10%	-11%	4%	9%	69%	12%	-17%
Income tax expense	\$4,816	\$4,758	\$5,691	\$4,977	\$20,242	\$3,843	\$4,577	\$5,626	\$5,075	\$19,121	\$16,713
<i>Effective tax rate</i>	28.8%	27.1%	29.9%	46.5%	31.6%	25.8%	25.0%	27.2%	28.0%	26.6%	28.0%
Net income before preferred dividends	\$11,923	\$12,827	\$13,359	\$5,737	\$43,846	\$11,062	\$13,701	\$15,071	\$13,049	\$52,883	\$42,976
<i>% change annual</i>	42%	13%	13%	-69%	-13%	-7%	7%	13%	127%	21%	-19%
Preferred dividends	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Net income available to common shareholders	\$11,923	\$12,827	\$13,359	\$5,737	\$43,846	\$11,062	\$13,701	\$15,071	\$13,049	\$52,883	\$42,976
<i>% change annual</i>	42%	13%	13%	-69%	-13%	-7%	7%	13%	127%	21%	-19%
Operating income¹	\$11,918	\$12,793	\$15,258	\$19,094	\$59,062	\$11,045	\$13,690	\$13,800	\$13,049	\$51,583	\$42,976
<i>% change annual</i>	42%	13%	30%	3%	18%	-7%	7%	-10%	-32%	-13%	-17%
Diluted operating EPS	\$0.59	\$0.63	\$0.75	\$0.94	\$2.90	\$0.54	\$0.67	\$0.67	\$0.64	\$2.52	\$2.10
<i>% change annual</i>	41%	13%	29%	2%	17%	-8%	6%	-10%	-32%	-13%	-17%
Average diluted shares²	20,234	20,306	20,422	20,420	20,346	20,450	20,457	20,488	20,490	20,471	20,500
<i>% change annual</i>	0%	0%	1%	1%	0%	1%	1%	0%	0%	1%	0%
Operating return on equity—diluted	20.0%	20.6%	23.4%	28.0%	23.1%	15.6%	18.6%	17.7%	16.0%	17.0%	12.1%
Book value per share—diluted	\$12.01	\$12.55	\$13.07	\$13.63	\$13.63	\$14.04	\$14.82	\$15.63	\$16.27	\$16.27	\$18.36
100-basis-point change in combined ratio	\$0.03	\$0.03	\$0.02	\$0.02	\$0.10	\$0.03	\$0.02	\$0.02	\$0.02	\$0.09	\$0.09

¹Income before the effects of net realized investment gains/losses.

²On a fully converted basis for Series C&D preferred stock and on a pro forma basis for the completion of the IPO in November, 2005.

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 10/31/09)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	64	Outperform (Buy)	3
Market Perform (Hold)	36	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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