

# Argo Group International Holdings, Ltd.

## Quick First Look at Third-Quarter Results: Difficult Quarter, Underlying Profitability Under Pressure, Estimates Should Come Down

### Highlights

- Disappointing quarter; results continue to be highly volatile.** Argo Group reported third-quarter operating EPS of \$0.82, which is management's estimate of net income excluding the impact from foreign exchange and realized investment gains, using a normalized tax rate. Our estimate was \$1.21 per share and the consensus estimate was \$1.04 (although we do not know how other analysts treated foreign exchange losses and other nonoperating adjustments). Underperformance was driven by deterioration in underlying profitability within excess and surplus lines, continued poor performance at Heritage, lower net investment income, and a \$0.12 per share charge related to a binding arbitration decision within the company's run-off operations. The company is holding a call on November 3 at 10:00 a.m. Eastern time.
- Premium growth excluding Heritage was in line with expectations.** Gross written premiums increased 6%, to \$506 million, given the benefits to top-line growth from the Heritage acquisition, which exceeded our estimate, as we have underestimated the contribution from Heritage from an accounting perspective and estimating the contribution remains challenging. Gross written premium decreased 3%, to \$360 million, excluding the international specialty segment (Heritage), largely in line with our estimate; this was due to better growth in commercial specialty, offset by a decline in reinsurance and excess and surplus lines—the latter largely consistent with results from peers in the space. Pricing remains under pressure, and we do not expect a sharper recovery until underlying profitability for the industry comes under more significant pressure.
- Underwriting profitability under pressure; Heritage performance remains disappointing.** The combined ratio was 98.6% this quarter, compared with 95.8% last quarter, our 95.4% estimate, and 106.1% in third quarter 2008, which included above-average catastrophe losses. The combined ratio excluding favorable loss development was 101.3% compared with our 95.2% estimate, given continued poor results at Heritage and deterioration in results within excess and surplus lines. Favorable loss reserve development was \$9.5 million compared with \$10.6 million in third quarter 2008.

### Financial | Commercial P/C Insurance

November 02, 2009

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

Symbol: AGII (NASDAQ)  
Price: \$34.38 (52-Wk.: \$24-\$37)  
Market Value (mil.): \$1,047  
Fiscal Year End: December  
Long-Term EPS Growth Rate: 12%  
Dividend/Yield: None

	2008A	2009E	2010E
<b>Estimates</b>			
EPS Q1	\$1.17	A\$1.13	NA
Q2	\$0.77	A\$1.26	NA
Q3	\$0.10	\$1.21	NA
Q4	\$0.76	\$1.16	NA
FY	\$2.81	\$4.77	\$4.80
CY		\$4.77	\$4.80

<b>Valuation</b>			
FY P/E	12.2x	7.2x	7.2x
CY P/E		7.2x	7.2x

### Trading Data (Thomson Financial)

Shares Outstanding (mil.)	31
Float (mil.)	NA
Average Daily Volume	131,976

### Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	20.6
Book Value Per Share (MRQ)	46.4
Enterprise Value (mil.)	1,412.6
EBITDA (TTM)	214.7
Enterprise Value/EBITDA (TTM)	6.6x
Return on Equity (TTM)	3.6

### Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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- **Modest net realized investment gain in the quarter, book value growth better.** The company realized a net pretax gain of \$0.7 million in its investment portfolio, up from a \$9.2 million loss last quarter, \$11.8 million loss in the first quarter, and \$18.4 million loss in third quarter 2008—off of a \$4.3 billion portfolio. Diluted book value per share increased more than 7.4% during the quarter to \$51.04 per share, given the recovery in credit markets. Argo announced its first-ever share-repurchase authorization earlier in 2008, but has not repurchased any stock so far. Some repurchase activity would seem warranted at the current valuation level.
- **Maintaining rating, estimates likely to come down.** 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 historic valuation levels as limiting downside. We stress that Argo Group's earnings are the least visible of any insurance company we cover given recent acquisitions, recent volatility, an above-average catastrophe loss exposure within our universe, a continued legacy loss reserve exposure, and now the impact from foreign exchange. Despite the volatility, we like Argo Group because we believe the company has several opportunities for better expense management and more aggressive capital management as its run-off businesses wind down that should have a positive impact on margins. Shares still trade at nearly a 33% discount to third quarter 2009 book value per share of \$51.04, given its below-average profitability.

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

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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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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