

Commercial Property/ Casualty Insurance

Third-Quarter Earnings Results Developing as Expected so Far

In this note we provide some brief insight from the first week of property-casualty insurance earnings results. Earnings season for our covered companies begins this week with ACE scheduled to report earnings after the market close on Tuesday, October 27. Please see our preview note dated October 7, for detailed discussion on all P&C covered companies.

—Highlights

- **Pricing Remains Under Pressure**

The pricing environment remains effectively unchanged from the second quarter, in our view—negative in the aggregate, despite some modest signs of rate stabilization within select stressed areas of the market. We believe that certain companies are attempting to hold the line on pricing this quarter compared with prior quarters, likely opting to walk away from business rather than continue to compromise on rate. However, success at this point has been limited, in our opinion. For example, specialty insurer RLI Corp. (discussed below) saw an aggregate 2% decline in rate within its casualty book during the third quarter; however, management stated that it believed that the rate decline for the company would be less than the overall industry given its margin discipline and willingness to walk away from business that lacked adequate pricing. While competitive pricing behavior over the past few years has been enabled by continued profitability in the industry boosted by favorable loss reserve development, it has been our basic view since mid-September 2008 that underlying margins are still too high for the commercial property-casualty insurance industry to push for price increases aggressively, despite capital pressures in the face of a recession. While fiscal 2008 was one of the most profitable years in the history of the industry, and favorable loss trends coupled with a benign catastrophe season this year has kept profitability strong year-to-date, we do believe we are nearing an inflection point for the industry and believe that a more marked deterioration in industrywide profitability is imminent due to nearly five consecutive years of price declines and a likely exhaustion of reserve redundancies over the next few quarters.

- **Weak Economy Taking Center Stage**

One key theme permeating third-quarter results for P&C companies so far is that recessionary pressures have taken over as the key culprit contributing to a more sober outlook on pricing improvements and driving declines in exposure growth, in our opinion. Workers' compensation is the clearest example cited so far this season with significant drops in payroll. In addition, corporate budgets are being squeezed and insurance premiums are an easy target for cost reductions, in our opinion. Economic headwinds are also having a significant negative impact on insurance brokers, particularly on consulting revenue, in our view. According to second quarter 2009

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Mark Lane
312.364.8686
mlane@williamblair.com

Rachel Carter
312.364.8962
rcarter@williamblair.com

industry results provided by ISO and the Property Casualty Insurers Association of America (PCI), net written premiums in the second quarter declined 4.8%—the ninth consecutive quarterly decline. If this trend continues through the balance of the year—which we believe is likely given that exposure growth is a lagging economic indicator—2009 will mark the first three-year consecutive decline in premiums since the Great Depression. The silver lining of economic weakness is that underwriting discipline appears to be returning to the market in certain segments and some companies appear more willing to walk away from business that lacks adequate rate, in addition to holding firm on terms and conditions, in our view.

- **Concerns of Claims Inflation; The Topic Du Jour**

A key topic that appears to be emerging in the market is that of claims inflation. As the economy stabilizes, or at a minimum the pace of decline slows, the inevitable emergence of inflation will be a key driver of further margin pressure, in our view. We believe the potential for claims inflation will become more of focus over the next few quarters and will serve as a key catalyst for higher prices eventually.

- **Benign Cats and Favorable Development Driving Outperformance**

The benign third-quarter hurricane season is a welcome reprieve in light of the recessionary headwinds and persistently soft market conditions discussed above. As expected we have seen the benefit from a quiet storm season translate into lower combined ratios for the catastrophe-exposed companies that have reported earnings so far this season. In addition, comparisons for catastrophe-exposed companies have been favorable this quarter, as 2008 marked the fourth-most costly catastrophe-loss year, and September 2008 produced Ike, the third-most costly hurricane in U.S. history. However, unwelcome fallout from the absence of catastrophes this season is the renewed price sensitivity of customers within the segment.

Favorable loss development (reduction in loss estimates from prior years) has continued to benefit underwriting margins so far this quarter, and has been a key reason for outperformance for companies that have reported third-quarter results. While we anticipate some level of favorable loss reserve development to continue over the next few quarters as the 2004 to 2006 accident years continue to develop favorably, we believe the volume of favorable development realized over the past few quarters will begin to decline, as reserves from those accident years are right-sized and adverse development from late 2007 and 2008 begin to materialize.

- **Strong Sequential Growth in Book Value Again**

We expect a strong increase in book value for the third quarter, with growth in the high-single digits, consistent with results so far this earnings season. September marked the seventh consecutive month of gains for the S&P 500 and production in the second and third quarters marked the largest back-to-back quarterly growth for the index since 1975. Credit markets also improved, according to data provided by *Moody's Investors Service*, average corporate bond spreads declined over 23% in the third quarter, and declined over 65%, year to date. The improvement in unrealized losses flows through shareholders' equity and not through net income. Commercial real estate remains one of the few major areas that continued to deteriorate in the third quarter, however, none of the names in our P&C coverage list have an inordinate amount of exposure to CMBS, and those that have modest exposure also employ conservative impairment policies, therefore shielding the group from outsized CMBS-related investment losses. Given that none of the companies on our list have high-risk investment portfolios, we are not expecting sharp reversals in unrealized investment losses that may be seen in other names or segments within the broad insurance sector.

- **Third-Quarter Results for Key Companies in the Space**

Specialty Insurer: RLI Corp. (RLI \$51.11, not covered) RLI Corp. was the first specialty insurer to report third-quarter earnings, reporting after the market close on October 19. The company earned \$1.18 per share, compared with consensus estimate of \$0.98 per share. Outperformance was driven by \$0.45 per share of favorable development, compared with \$0.49 of favorable development last quarter, all from the casualty book, which more than offset adverse development from RLI's property book. Net written premiums declined by 9.8%

from the prior-year period, as management explained the decline in growth reflected an intentional contraction in the business as margins were unacceptable to compensate the company for risks it was being asked to assume. Book value per share increased 8.2% sequentially, given further strengthening in credit and equity markets. We view RLI's results as largely representative of our expectations for the specialty lines segment broadly this quarter.

Insurance Broker: Brown & Brown, Inc. (BRO \$18.66, not covered). Brown & Brown was the first insurance broker in the industry to report third-quarter earnings, reporting after the market close on October 19. The company earned \$0.29 per share compared with consensus estimate of \$0.28 per share. Organic growth was negative 5.2%, down from negative 4.2% in the second quarter. We view the organic growth result as slightly more negative than current expectations, but in general the results support our view that pricing remains under pressure and the negative impact on exposure growth given the recession is likely to have a more pronounced impact on results than originally anticipated, particularly for insurance brokers. Brown & Brown's organic growth has been lagging the past few quarters, in part because it is a U.S.-only company and growth has been faster overseas, and because market share gains at certain competitors, including Aon, have been stronger in the United States.

Aon is scheduled to release third-quarter results before the open on Friday, October 30. We estimate 0.0% to 2.0% organic growth in the third quarter, compared with 0% growth last quarter. Marsh & McLennan is scheduled to release third-quarter results before the open on Wednesday, November 4. We estimate 2% organic growth in the third quarter, compared with 2% organic growth last quarter. We favor Aon relative to Marsh & McLennan given superior execution and less economic sensitivity in its business.

Major Insurers: The Travelers Companies, Inc. (TRV \$51.30; not covered) and Chubb Corp. (CB \$50.64; not covered). Travelers and Chubb were the first major insurers to report third-quarter earnings, Travelers before the market open, and Chubb after the market close on October 22. Travelers beat estimates, earning \$1.61 per share, compared with consensus of \$1.31 per share, representing an annualized operating ROE of 14.1%. Outperformance was driven by net favorable prior-year reserve development of \$202 million after-tax and \$46 million of after-tax favorable development on the current year loss ratios for the first half of 2009. The combined ratio in the third quarter was 89.1%, including the impact from catastrophe losses and favorable development, compared with 104.5% in third quarter 2008. Management increased its 2009 earnings guidance to account for its strong performance year-to-date and to account for expected share-repurchase activity in the fourth quarter. While management stated that it was cautious on its ability to push for significant rate increases in the near term, the company was able to achieve positive renewal rate changes among its three major business units. Importantly, while the company experienced a 3% decline in net written premiums compared with the prior year, management stated that the renewal rate changes were positive enough to offset the impact from lower exposure growth. Third-quarter book value per share increased 8.4% sequentially to \$51.24, reflective of the strength in equity and credit markets.

Chubb also beat estimates, earning \$1.56 per share, compared with consensus of \$1.27 per share, representing an annualized operating ROE of 15.5%. Performance benefited from \$205 million (7.0 percentage point benefit to the combined ratio) of favorable development in the quarter, comparable with year-ago levels. Third-quarter net written premiums declined by 7% from the year-ago period, and declined by 5% on a constant currency basis. Management attributed the decline in premium growth to the weak economy and reiterated that it was focused on growing the bottom line rather than the top line. That said, in Chubb's U.S. commercial business it was able to achieve an overall 3% increase in renewal rates with a retention percentage in the low-80s. Within its U.S. professional liability book, Chubb was able to achieve 3% renewal rate increases, the third consecutive quarter of rate improvement in this segment, with a retention percentage of 84. The third-quarter combined ratio was 85.4% compared with 98.1% in third quarter 2008. Catastrophe losses only accounted for 0.8 percentage points of the ratio, compared with 13.6 percentage points in the year-ago period, which included Hurricane Ike. Management also increased its 2009 earnings guidance to account for its strong performance during the quarter. Third-quarter book value per share

increased 9.6% sequentially to \$45.43, reflective of the strengthening in equity and credit markets.

• **Names to Watch This Season From Our Coverage List**

ACE is the first P&C insurer on our list to report earnings this quarter, scheduled for after market close, October 27, and we favor ACE on the large-cap side as we believe it is the best-managed and most-dynamic of its large-cap peers. We favor First Mercury on the small-cap side, and believe there could be upside relative to our estimate if First Mercury's property business improved in the quarter relative to last quarter's disappointing loss. We also favor Argo Group on the small-cap side as the company has several opportunities for better expense and capital management and the stock is arguably among the least expensive of all publicly traded underwriters, partly a reflection of the complexity of the company's development the past few years, and some volatility in reported results. We stress that Argo Group's earnings are the least visible of any company within our insurance coverage universe, given a continued legacy of loss reserve exposure.

We remain selective in the space as we view the deterioration in industrywide profitability as imminent, due to nearly five consecutive years of price declines and a likely exhaustion of reserve redundancies over the next few quarters. Outside of deterioration in profitability, or some unforeseen major stock loss, we see no other catalyst on the horizon to drive price improvements for the industry. Despite expected deterioration in profitability, we view existing valuation levels as attractive for the group. Without regard to the near-term fundamental outlook, buying the group near GAAP book value per share (approximately 1.0 times based upon our September 30, 2009 estimate—ex-Insurance Brokers) has proved to be a good investment over any reasonable period of time. Valuation is 10% cheaper than levels in early March 2000, a period in which investors were convinced the group was no longer an investable space. The group appreciated by roughly 90% between March 3, 2000, and December 31, 2000.

Commercial P/C Insurance Third Quarter Earnings Data

Ticker	Curr Price 10/23/2009	Rating	3Q09 Earnings Release	3Q09E EPS			2009E EPS			2010E EPS	
				Wm Blair Current Est.	Consensus	3Q08	Wm Blair Current Est.	Consensus	2008	Wm Blair Current Est.	Consensus
ACE	\$54.38	Outperform	October 27, After Close	\$2.05	\$1.97	\$1.51	\$8.19	\$7.99	\$7.72	\$7.90	\$7.85
AMSF	\$18.79	Market Perform	November 5, After Close	\$0.59	\$0.54	\$0.75	\$2.40	\$2.32	\$2.90	\$2.10	\$2.15
AGII	\$34.80	Outperform	November 3, After Close	\$1.21	\$1.04	\$0.10	\$4.77	\$4.58	\$2.81	\$4.80	\$4.73
FMR	\$13.34	Outperform	November 2, After Close	\$0.35	\$0.37	\$0.39	\$1.40	\$1.44	\$1.74	\$1.85	\$1.66
HCC	\$27.64	Market Perform	November 3, After Close	\$0.75	\$0.74	\$0.61	\$3.05	\$2.97	\$2.80	\$3.10	\$3.07
AOC	\$40.50	Market Perform	October 30, Before Open	\$0.66	\$0.66	\$0.69	\$3.05	\$3.03	\$2.90	\$3.40	\$3.44
MMC	\$24.89	Market Perform	November 4, Before Open	\$0.31	\$0.26	\$0.21	\$1.45	\$1.37	\$1.45	\$1.90	\$1.75

Source: Thomson, company reports, William Blair & Company L.L.C. estimates

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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William Blair & Company, L.L.C. 222 West Adams Street Chicago, Illinois 60606 312.236.1600 www.williamblair.com

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