

Commercial P/C Insurance

Third-Quarter Preview: Deterioration in Profitability Necessary to Drive Higher Pricing; Valuation Remains Attractive, Room for Exposure to Space in Balanced Portfolio

Financial | Commercial P/C Insurance

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—Highlights

- **Pricing remains under pressure; improvement may not materialize until 2010 at the earliest.** The pricing environment remains effectively unchanged from second quarter, in our view—negative in the aggregate despite some modest signs of rate stabilization within select stressed areas of the market. A rapid recovery in equity and credit markets, strong first-half underwriting margins, and minimal catastrophe losses in the third quarter have all dampened any enthusiasm for higher rates in 2009. Property catastrophe reinsurance, energy, and directors' and officers' (D&O) liability insurance remain the main areas experiencing moderate stabilization, with aviation seeing some rate hardening. While AIG (AIG \$44.83) is still playing a role in perpetuating widespread aggressive pricing behavior, it appears to no longer bear the brunt of the blame for the sustained soft market. Competitive pressures exist in most areas of the market, albeit still the most-pronounced among large accounts and casualty lines, intensifying as the recession has chipped away at the exposure base causing market participants to battle more intensely for share of a smaller market. Competitive pricing behavior across the board has been enabled by continued profitability in the industry boosted by favorable loss reserve development. Our basic view since mid-September 2008 has been 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; therefore, we believe the primary catalyst toward a further push in pricing is further deterioration in underwriting margins and profitability after more than four consecutive years of price declines. Fiscal 2008 was one of the most profitable years in the history of the industry, based on underwriting margins. We believe the contraction in profitability may not materialize until late this year, which coupled with a weak economy, could delay a widespread improvement in pricing until at least mid-2010, in our view.
- **Economic pressures continue to constrain premium growth.** The impact from recessionary pressures has also contributed to a more sober outlook on pricing improvements and subdued expectations for exposure growth, in our view. Economic headwinds also continue to have a significant negative impact on consulting revenue for the insurance brokers, likely limiting organic growth in the near term. According to second quarter 2009 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, 2009 will mark the first three-year consecutive decline in premiums since the Great Depression, when according to the Insurance

Mark Lane
312.364.8686
mlane@williamblair.com

Rachel Carter
312.364.8962
rcarter@williamblair.com

Information Institute, the industry experienced four consecutive years of premiums declines from 1930 through 1933. That said, many of the names on our list, particularly ACE and HCC, have benefited somewhat from a flight-to-quality, and virtually every name on our list has seen some windfall from the troubles at AIG, insulating many of our P&C names from severe declines in premium growth, at least in the near-term.

- **Benign catastrophe season should drive upward earnings revisions for companies with property catastrophe exposure—taking estimates up for ACE, Argo Group, and HCC Insurance on our list.** The benign third-quarter hurricane season year-to-date is a welcome reprieve in light of the recessionary headwinds and persistently soft market conditions discussed above. We expect a number of upward earnings revisions to result from tame catastrophe losses in the third quarter; and our own earnings revisions are discussed in the company-specific sections below. Comparisons for catastrophe-exposed companies should be 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.
- **Favorable development expected to continue, unclear when redundancies will dissipate, expect more well into 2010.** We expect a decline in the contribution from favorable loss reserve development (reduction in loss estimates from prior years) on underwriting margins this quarter. 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. Favorable development has been a strong contributor to underwriting margins the past few quarters and as this activity subsides, it may spark insurers to more-aggressively pursue rate increases as declining underlying profitability becomes more evident.
- **Expect continued strong growth in industry book value, given continuing strength in earnings and credit markets.** We expect a strong increase in book value for the third quarter, with growth estimates once again in the high-single-digit percentage range, similar to strong growth in the second quarter, which was the first increase for the industry following sequential book value declines over the prior several quarters. The expected increase in book value is once again driven by a reduction in unrealized losses due to the improvement in credit markets and equity markets, with tightening of corporate bond spreads broadly and a 15.0% increase in the S&P 500 (last quarter the S&P 500 increased 15.6%). 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.
- **Valuation alone should warrant some exposure to space, particularly for those with more defensive mindset.** 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 shock loss, we see no other catalyst on the horizon to drive price improvements for the industry. In terms of valuation, the one factor that could unlock some value in lieu of an immediate improvement in pricing for the industry is the prospect for some acquisitions of smaller names in the space as credit markets continue to stabilize or a merger of equals of certain major players. In the beginning of 2009, weak capital positions for insurance companies was touted as a key driver of M&A activity, however, given the combination of recovering investment portfolios and a benign catastrophe loss year, capital positions have materially improved strengthening the resolve of would-be targets to hold out for better offers. Once the M&A market does reignite, it should drive valuations closer to the historical mean, in our opinion. 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 12% 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 10/6/2009 | Rating | Preliminary 3Q09 Earnings Release | 3Q09E EPS | | | | 2009E EPS | | | | 2010E EPS | | |
|--------|-------------------------|----------------|--------------------------------------|---------------------------|--------------------------|-----------|--------|---------------------------|--------------------------|-----------|--------|---------------------------|--------------------------|-----------|
| | | | | Wm Blair Original Est. | Wm Blair Current Est. | Consensus | 3Q08 | Wm Blair Original Est. | Wm Blair Current Est. | Consensus | 2008 | Wm Blair Original Est. | Wm Blair Current Est. | Consensus |
| ACE | \$54.66 | Outperform | October 27, After Close | \$1.53 | \$2.05 | \$1.80 | \$1.51 | \$7.55 | \$8.19 | \$7.85 | \$7.72 | \$7.90 | \$7.90 | \$7.85 |
| AMSF | \$17.11 | Market Perform | Week of Nov. 2 | \$0.59 | \$0.59 | \$0.54 | \$0.75 | \$2.40 | \$2.40 | \$2.32 | \$2.90 | \$2.10 | \$2.10 | \$2.15 |
| AGII | \$34.35 | Outperform | Week of Nov. 2 | \$0.84 | \$1.21 | \$0.91 | \$0.10 | \$4.39 | \$4.77 | \$4.54 | \$2.81 | \$4.80 | \$4.80 | \$4.71 |
| FMR | \$14.01 | Outperform | Week of Oct. 26 | \$0.35 | \$0.35 | \$0.36 | \$0.39 | \$1.40 | \$1.40 | \$1.43 | \$1.74 | \$1.85 | \$1.85 | \$1.66 |
| HCC | \$27.55 | Market Perform | November 3, After Close | \$0.69 | \$0.75 | \$0.71 | \$0.61 | \$2.97 | \$3.05 | \$2.97 | \$2.80 | \$3.10 | \$3.10 | \$3.07 |
| AOC | \$41.01 | Market Perform | Week of Oct. 26 | \$0.66 | \$0.66 | \$0.66 | \$0.69 | \$3.05 | \$3.05 | \$3.03 | \$2.90 | \$3.40 | \$3.40 | \$3.44 |
| MMC | \$24.25 | Market Perform | Week of Nov. 2 | \$0.31 | \$0.31 | \$0.26 | \$0.21 | \$1.45 | \$1.45 | \$1.37 | \$1.45 | \$1.90 | \$1.90 | \$1.75 |

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

Top Stock Picks From Our Coverage List:

- ACE Limited, core name.** We favor ACE among large-cap underwriters: we believe it is the best managed and most dynamic of its large-cap peers (includes Chubb [CB \$50.61] and Travelers [TRV \$49.53]), and valuation remains attractive on an absolute and relative basis. We believe ACE will manage its way more adeptly through a market cycle versus industry peers. In addition, we continue to view ACE as defensive among financial services companies, given its lack of business model risk, the quality of its franchise, diversification, financial flexibility, and strong execution the past few years. The shares currently trade at 1.02 times estimated third-quarter book value per share excluding OCI of \$53.77—3.4% sequential growth, and we view any entry-point below GAAP book value excluding OCI as attractive over any reasonable period of time. We expect GAAP book value (including the impact from OCI) to increase by roughly 7% this quarter, compared with a sequential increase of over 12% last quarter, given strong earnings growth and a reduction in unrealized investment losses. ACE is the only name in our coverage list where there has been a significant divergence between GAAP book value excluding OCI, and GAAP book value including OCI.

We estimate a 35% increase in third-quarter operating EPS, to \$2.05 (previous estimate was \$1.53), compared with consensus of \$1.80. There could be some more upside from greater favorable loss reserve development—\$0.21 per share compared to a \$0.27 run-rate in the first half. We are increasing our 2009 EPS estimate to \$8.19 from \$7.55. We expect management's operating EPS guidance range for 2009 to increase as well from the \$7.25 to \$8.00 range provided on the second-quarter earnings call, which included roughly \$215 million of after-tax of catastrophe losses in the second half of the year and no provision for additional favorable development, which includes roughly \$0.54 per share from favorable development in the first half. Excluding catastrophe losses and additional favorable development, management's 2009 EPS range is roughly \$7.90 to \$8.65, compared with our revised 2009 EPS estimate excluding catastrophe losses and second-half favorable loss reserve development of \$8.05. We expect favorable loss reserve development in the third quarter to continue to have a positive impact on underwriting margins, with our third-quarter estimate at \$90 million pretax (roughly \$0.21 per share after-tax), compared with \$277 million pretax third quarter 2008 and \$158 million pretax last quarter. We decreased our catastrophe loss estimate for the quarter to \$50 million from \$235 million to account for the lack of catastrophes in the quarter. We estimate an 88.5% third-quarter combined ratio excluding the life segment, 86.8% excluding catastrophe losses, and 89.9% excluding catastrophe losses and favorable loss reserve development, compared with 87.8%, 86.7%, and 92.1% last quarter, respectively.

We are forecasting a 2.0% increase in net written premiums in the third quarter, compared with an 8.2% increase in the year-ago period that benefited from the Combined Insurance acquisition, and a decline of 5.5% last quarter. This is the second quarter that the Combined Insurance acquisition is fully incorporated into both periods. Our growth estimate is largely driven by some product mix

changes, as our gross written premium estimate is down 2%. Our estimate could prove a little aggressive, given our industry views detailed above and because ACE has demonstrated disciplined underwriting through this period; it was willing to turn away business that lacked adequate rate. Consequently the average rate on new business may be higher than peers; however we expect if this is the case it will also be reflected in lower retention levels. Changes in reserve levels for ACE's life reinsurance business can be highly variable with low visibility, as levels are based on assumptions related to expenses, mortality, investment yields, etc. Given the improvement in the S&P 500 Index during the third quarter, this is not a concern compared with prior quarters.

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

| | 1Q08 | 2Q08 | 3Q08 | 4Q08 | 2008 Actual | 1Q09 | 2Q09 | 3Q09E | 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 | \$4,740 | \$4,008 | \$17,631 | \$18,533 |
| % change annual | -2% | 7% | 11% | -3% | 3% | -4% | -3% | -2% | 3% | -2% | 5% |
| Net premiums written | \$3,049 | \$3,224 | \$2,928 | \$2,681 | \$11,882 | \$3,078 | \$3,048 | \$2,988 | \$2,739 | \$11,853 | \$12,727 |
| % change annual | -4% | 8% | 8% | -1% | 2% | 1% | -5% | 2% | 2% | 0% | 7% |
| % gross premiums written | 70.8% | 66.3% | 60.5% | 68.6% | 66.3% | 74.2% | 64.4% | 63.0% | 68.3% | 67.2% | 68.7% |
| Net premiums earned | \$2,840 | \$3,061 | \$3,265 | \$2,867 | \$12,033 | \$2,859 | \$2,902 | \$2,946 | \$2,961 | \$11,668 | \$12,290 |
| % change annual | -5% | 5% | 7% | -3% | 1% | 1% | -5% | -10% | 3% | -3% | 5% |
| Loss and loss expense | \$1,579 | \$1,785 | \$2,265 | \$1,654 | \$7,283 | \$1,704 | \$1,688 | \$1,751 | \$1,753 | \$6,896 | \$7,527 |
| % premiums earned | 55.6% | 58.3% | 69.4% | 57.7% | 60.5% | 59.6% | 58.2% | 59.4% | 59.2% | 59.1% | 61.2% |
| Adverse loss reserve development | (\$137) | (\$104) | (\$277) | (\$252) | (\$770) | (\$68) | (\$158) | (\$90) | (\$82) | (\$398) | (\$165) |
| Catastrophe losses | \$31 | \$58 | \$411 | \$67 | \$567 | \$38 | \$31 | \$50 | \$61 | \$180 | \$400 |
| Loss ratio—ex cats and development | 59.3% | 59.8% | 65.3% | 64.1% | 62.2% | 60.7% | 62.5% | 60.8% | 59.9% | 61.0% | 59.3% |
| Underwriting expense | \$783 | \$864 | \$901 | \$796 | \$3,344 | \$763 | \$820 | \$819 | \$823 | \$3,224 | \$3,450 |
| % premiums earned | 27.6% | 28.2% | 27.6% | 27.8% | 27.8% | 26.7% | 28.3% | 27.8% | 27.8% | 27.6% | 28.1% |
| Corporate administrative expense | \$39 | \$39 | \$33 | \$42 | \$153 | \$35 | \$39 | \$38 | \$38 | \$150 | \$153 |
| % premiums earned | 1.4% | 1.3% | 1.0% | 1.5% | 1.3% | 1.2% | 1.3% | 1.3% | 1.3% | 1.3% | 1.2% |
| Underwriting income | \$439 | \$373 | \$66 | \$375 | \$1,253 | \$357 | \$355 | \$339 | \$348 | \$1,398 | \$1,161 |
| % change annual | 15% | 4% | -81% | 7% | -13% | -18% | -4% | 413% | -7% | 12% | -17% |
| Combined ratio | 84.5% | 87.8% | 98.0% | 86.9% | 89.6% | 87.5% | 87.8% | 88.5% | 88.3% | 88.0% | 90.6% |
| Net investment income—P/C | \$474 | \$492 | \$480 | \$474 | \$1,920 | \$456 | \$463 | \$482 | \$482 | \$1,883 | \$1,975 |
| % change annual | 8% | 8% | 0% | -3% | 3% | -4% | -6% | 0% | 2% | -2% | 5% |
| Pretax operating income | \$913 | \$865 | \$546 | \$849 | \$3,173 | \$813 | \$818 | \$821 | \$829 | \$3,281 | \$3,135 |
| % change annual | 11% | 6% | -34% | 1% | -4% | -11% | -5% | 50% | -2% | 3% | -4% |
| Life Insurance | | | | | | | | | | | |
| Pretax operating income | \$31 | \$81 | \$85 | \$21 | \$218 | \$67 | \$78 | \$68 | \$76 | \$289 | \$349 |
| % change annual | -24% | 84% | 93% | -32% | 36% | 116% | -4% | -20% | 260% | 32% | 21% |
| Interest expense | \$46 | \$62 | \$68 | \$54 | \$230 | \$53 | \$56 | \$56 | \$54 | \$219 | \$215 |
| Other income | \$13 | \$5 | \$17 | (\$17) | \$18 | (\$17) | \$13 | \$3 | \$3 | \$2 | \$3 |
| Pretax income | \$911 | \$889 | \$580 | \$799 | \$3,179 | \$810 | \$853 | \$836 | \$854 | \$3,352 | \$3,272 |
| % change annual | 12% | 8% | -30% | -4% | -4% | -11% | -4% | 44% | 7% | 5% | -2% |
| % total revenue | 26.6% | 22.4% | 14.0% | 21.3% | 20.8% | 21.9% | 22.6% | 21.8% | 22.1% | 22.1% | 20.4% |
| Income tax expense | \$186 | \$151 | \$76 | \$175 | \$588 | \$141 | \$147 | \$145 | \$158 | \$591 | \$602 |
| Effective tax rate | 20.4% | 17.0% | 13.1% | 21.9% | 18.5% | 17.4% | 17.2% | 17.4% | 18.5% | 17.6% | 18.4% |
| Income excluding realized gains | \$725 | \$738 | \$504 | \$624 | \$2,591 | \$669 | \$706 | \$690 | \$696 | \$2,761 | \$2,670 |
| % change annual | 9% | 11% | -27% | -10% | -4% | -8% | -4% | 37% | 11% | 7% | -3% |
| Net realized investment gains/(losses) | (\$348) | \$8 | (\$450) | (\$604) | (\$1,394) | (\$102) | (\$171) | \$0 | \$0 | (\$273) | \$0 |
| Net income | \$377 | \$746 | \$54 | \$20 | \$1,197 | \$567 | \$535 | \$690 | \$696 | \$2,488 | \$2,670 |
| % change annual | -46% | 15% | -92% | -97% | -54% | 50% | -28% | 1179% | 3378% | 108% | 7% |
| 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 | \$690 | \$696 | \$2,761 | \$2,670 |
| % change annual | 10% | 11% | -26% | -8% | -4% | -6% | -3% | 37% | 11% | 8% | -3% |
| Diluted operating EPS | \$2.16 | \$2.18 | \$1.51 | \$1.87 | \$7.72 | \$1.99 | \$2.09 | \$2.05 | \$2.06 | \$8.19 | \$7.90 |
| % change annual | 9% | 10% | -27% | -9% | -4% | -8% | -4% | 35% | 10% | 6% | -4% |
| Average diluted shares | 331 | 333 | 333 | 333 | 333 | 336 | 338 | 338 | 338 | 337 | 338 |
| Operating return on equity—diluted | 17.7% | 17.8% | 12.7% | 16.8% | 16.3% | 18.4% | 18.1% | 16.1% | 15.5% | 16.9% | 13.8% |
| Book value per share—diluted | \$48.87 | \$49.00 | \$46.11 | \$43.40 | \$43.40 | \$43.79 | \$49.07 | \$52.29 | \$54.06 | \$54.06 | \$60.58 |

¹Excludes net realized investment gains/(losses).
Source: Company reports and William Blair & Company estimates

- **First Mercury Financial, more dynamic than its peers.** We also favor First Mercury on the lower-end of our market-cap range. We view First Mercury as a sound underwriting company with more dynamic growth opportunities over time relative to its peers. We also view the company as a legitimate takeover candidate at some point and would complement an onshore or offshore company with a broad specialty-lines platform. The company has also capitalized on strategic hiring opportunities, given weakness at select competitors, adding underwriters this year from AIG and XL Capital (XL \$17.60) and a former head underwriter from North Pointe Holdings. In addition, the company's new specialty business unit, FM Emerald, continues to gain traction, and American Management Corporation (AMC) could develop as potentially a major driver of production should pricing improve ahead of expectations (MGU in long-haul trucking). Our primary concern remains underlying profitability in the face of above-average growth the past few years, an intensely competitive environment, and a limited operating history outside core specialty lines. We view the disappointing underwriting results within the property business last quarter as an anomaly and containable, and believe an improvement in that business line this quarter will be viewed positively.

We estimate an 11% decline in third-quarter operating EPS to \$0.35, compared with consensus of \$0.36. We believe that we could see some upside in results from more-normalized results in the property line of business. The decline in earnings is driven principally by a higher loss ratio compared with the year-ago period given continued pressure on pricing, offset somewhat by a lower share count, given some share-repurchase activity over the prior 12 months. First Mercury is one of the few companies that have been booking much higher accident-year loss ratios relative to the industry, which we view as reflective of conservatism as the company has expanded into some new areas. We expect deterioration in underwriting profitability to be offset by continued improvement in performance at AMC. We estimate a 3.5% increase in gross written premiums produced, to \$80 million and estimate at least 1.5% growth for the year given the benefits from new business efforts at FM Emerald and recent new hires, but we would not be surprised to see top-line growth under a bit of pressure. Price competition remains fierce for the E&S market, as pressure from both new entrants and encroachment from admitted companies builds in the space. We estimate the combined ratio to be 92.3% this quarter, compared with 99.9% last quarter and 86.3% in the third quarter 2008. The increase in combined ratio in the second quarter was attributed to above-average property losses totaling \$5.2 million, which management believed could have been economically related. In response to the losses, the company has implemented significantly more conservative underwriting standards for its property business, limiting new business growth within this segment. Our combined ratio estimate includes just \$1.5 million favorable loss reserve development this quarter, compared with \$3.6 million last quarter. As mentioned above, First Mercury has been expanding its franchise into some new areas, and has been managing its growth conservatively by booking accident-year loss ratios much higher on year-over-year basis and has recognized significantly less favorable loss reserve development compared with industry peers. The shares trade at a 12% discount to estimated third-quarter book value per share excluding OCI of \$15.97, and we see no reason why First Mercury should trade at a discount to this level given its profitability profile (our GAAP book value estimate is above this level given unrealized gains in the investment portfolio).

First Mercury Financial Corporation
Condensed Income Statement Comparison
(\$ in millions, except per share data)

| | 1Q08 | 2Q08 | 3Q08 | 4Q08 | 2008 Actual | 1Q09 | 2Q09 | 3Q09E | 4Q09E | 2009 Estimate | 2010 Estimate |
|--|-----------------|-----------------|-----------------|-----------------|------------------|-----------------|-----------------|-----------------|-----------------|------------------|------------------|
| Gross premiums produced: | \$81,293 | \$79,862 | \$76,956 | \$83,155 | \$321,266 | \$77,878 | \$82,521 | \$79,649 | \$86,065 | \$326,114 | \$366,878 |
| % change annual | 27% | 2% | 16% | 24% | 16% | -4% | 3% | 4% | 4% | 2% | 13% |
| Gross premiums written: | \$81,206 | \$79,914 | \$76,999 | \$83,157 | \$321,276 | \$77,878 | \$82,521 | \$79,649 | \$86,065 | \$326,114 | \$366,878 |
| % change annual | 34% | 3% | 16% | 24% | 18% | -4% | 3% | 3% | 3% | 2% | 13% |
| % gross premiums produced | 99.9% | 100.1% | 100.1% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Net premiums written: | \$58,503 | \$52,241 | \$49,546 | \$59,660 | \$219,950 | \$49,825 | \$53,442 | \$51,772 | \$55,943 | \$210,982 | \$242,140 |
| % change annual | 70% | 19% | 40% | 44% | 41% | -15% | 2% | 4% | -6% | -4% | 15% |
| % gross premiums written | 72.0% | 65.4% | 64.3% | 71.7% | 68.5% | 64.0% | 64.8% | 65.0% | 65.0% | 64.7% | 66.0% |
| Net premiums earned | \$43,571 | \$46,559 | \$49,092 | \$54,522 | \$193,744 | \$52,594 | \$51,432 | \$54,097 | \$53,910 | \$212,033 | \$226,561 |
| % change annual | -3% | 7% | 19% | 38% | 15% | 21% | 10% | 10% | -1% | 9% | 7% |
| Loss and loss expense | \$23,444 | \$25,732 | \$27,537 | \$31,127 | \$107,840 | \$30,493 | \$35,463 | \$33,540 | \$33,424 | \$132,920 | \$132,765 |
| % premiums earned | 53.8% | 55.3% | 56.1% | 57.1% | 55.7% | 58.0% | 69.0% | 62.0% | 62.0% | 62.7% | 58.6% |
| Favorable/(unfavorable) loss reserve development | \$0 | \$0 | \$4,800 | \$0 | \$4,800 | \$750 | \$3,600 | \$1,500 | \$0 | \$5,850 | \$2,000 |
| % premiums earned | 0.0% | 0.0% | 9.8% | 0.0% | 2.5% | 1.4% | 7.0% | 2.8% | 0.0% | 2.8% | 0.9% |
| Acquisition costs | \$8,213 | \$9,096 | \$10,798 | \$13,057 | \$41,164 | \$13,329 | \$13,600 | \$12,983 | \$12,938 | \$52,851 | \$54,375 |
| % premiums earned | 18.8% | 19.5% | 22.0% | 23.9% | 21.2% | 25.3% | 26.4% | 24.0% | 24.0% | 24.9% | 24.0% |
| Insurance underwriting expenses | \$1,024 | \$4,266 | \$4,028 | \$3,681 | \$13,000 | \$2,660 | \$2,292 | \$3,408 | \$3,396 | \$11,756 | \$13,820 |
| % premiums earned | 2.4% | 9.2% | 8.2% | 6.8% | 6.7% | 5.1% | 4.5% | 6.3% | 6.3% | 5.5% | 6.1% |
| Expense ratio | 21.2% | 28.7% | 30.2% | 30.7% | 28.0% | 30.4% | 30.9% | 30.3% | 30.3% | 30.5% | 30.1% |
| Underwriting income | \$9,983 | \$7,202 | \$6,515 | \$7,675 | \$31,375 | \$6,443 | \$2,420 | \$11,165 | \$10,651 | \$30,680 | \$53,101 |
| % change annual | -13% | -34% | -41% | -36% | -31% | -35% | -66% | 71% | 39% | -2% | 73% |
| Combined ratio | 75.0% | 84.0% | 86.3% | 87.8% | 83.6% | 88.4% | 99.9% | 92.3% | 92.3% | 93.2% | 88.7% |
| Commissions and fees | \$4,053 | \$7,086 | \$4,757 | \$5,093 | \$20,989 | \$6,894 | \$9,577 | \$7,000 | \$6,500 | \$29,971 | \$27,500 |
| % change annual | 117% | 243% | 114% | -737% | 291% | 70% | 35% | 47% | 28% | 43% | -8% |
| Noninsurance company expenses | \$4,960 | \$7,349 | \$4,971 | \$4,075 | \$21,354 | \$6,563 | \$7,234 | \$6,500 | \$6,250 | \$26,547 | \$24,000 |
| % change annual | 122% | 201% | 104% | -863% | 224% | 32% | -2% | 31% | 53% | 24% | -10% |
| Insurance services income | (\$907) | (\$263) | (\$214) | \$1,018 | (\$365) | \$331 | \$2,343 | \$500 | \$250 | \$3,424 | \$3,500 |
| % insurance commissions/fees | -22.4% | -3.7% | -4.5% | 20.0% | -1.7% | 4.8% | 24.5% | 7.1% | 3.8% | 11.4% | 12.7% |
| Net investment income | \$4,848 | \$5,216 | \$5,571 | \$5,997 | \$21,632 | \$6,434 | \$7,132 | \$6,423 | \$6,448 | \$26,437 | \$27,692 |
| % change annual | 47% | 35% | 28% | 26% | 33% | 33% | 37% | 15% | 8% | 22% | 5% |
| % yield | 4.16% | 4.01% | 4.04% | 4.24% | 4.11% | 4.54% | 4.55% | 3.90% | 3.80% | 4.18% | 3.80% |
| Intangible asset amortization | \$399 | \$515 | \$553 | \$572 | \$2,039 | \$575 | \$575 | \$572 | \$572 | \$2,294 | \$2,294 |
| Interest expense | \$1,464 | \$1,476 | \$1,440 | \$1,440 | \$5,820 | \$1,416 | \$1,417 | \$1,440 | \$1,440 | \$5,713 | \$5,700 |
| Change in fair value of derivatives | \$435 | (\$262) | (\$64) | \$202 | \$311 | (\$106) | (\$123) | \$0 | \$0 | (\$229) | \$0 |
| Pretax operating income | \$12,533 | \$10,689 | \$10,157 | \$11,458 | \$44,837 | \$10,992 | \$7,683 | \$9,076 | \$8,837 | \$36,588 | \$48,799 |
| % change annual | -7% | -22% | -27% | -23% | -20% | -12% | -28% | -11% | -23% | -18% | 33% |
| Net realized investment gains/(losses) | \$1 | (\$1,812) | (\$10,604) | (\$8,271) | (\$20,686) | \$1,757 | \$9,547 | \$0 | \$0 | \$11,304 | \$0 |
| Income before taxes | \$12,534 | \$8,877 | (\$447) | \$3,187 | \$24,151 | \$12,749 | \$17,230 | \$9,076 | \$8,837 | \$47,892 | \$48,799 |
| % change annual | -8% | -38% | -103% | -78% | -57% | 2% | 94% | -2130% | 177% | 98% | 2% |
| Income tax expense | \$3,898 | \$2,641 | (\$948) | \$823 | \$6,414 | \$4,068 | \$5,621 | \$2,814 | \$2,739 | \$15,242 | \$14,933 |
| Effective tax rate | 31.1% | 29.8% | 212.1% | 25.8% | 26.6% | 31.9% | 32.6% | 31.0% | 31.0% | 31.8% | 30.6% |
| Net income from continuing operations | \$8,636 | \$6,236 | \$501 | \$2,364 | \$17,737 | \$8,681 | \$11,609 | \$6,263 | \$6,098 | \$32,650 | \$33,867 |
| % change annual | -4% | -34% | -95% | -76% | -53% | 1% | 86% | 1150% | 158% | 84% | 4% |
| Operating income from continuing operations¹ | \$8,918 | \$7,244 | \$7,352 | \$7,871 | \$31,385 | \$7,470 | \$5,324 | \$6,263 | \$6,098 | \$25,303 | \$33,867 |
| % change annual | -1% | -19% | -23% | -23% | -17% | -16% | -27% | -15% | -23% | -19% | 34% |
| Diluted operating EPS | \$0.47 | \$0.38 | \$0.39 | \$0.43 | \$1.68 | \$0.41 | \$0.30 | \$0.35 | \$0.34 | \$1.40 | \$1.85 |
| % change annual | -4% | -22% | -22% | -21% | -17% | -13% | -23% | -11% | -21% | -16% | 32% |
| Average diluted shares | 18,793.3 | 18,943.3 | 18,726.2 | 18,357.3 | 18,705.0 | 18,109.0 | 18,042.0 | 18,000.0 | 18,000.0 | 18,037.8 | 18,350.0 |
| % change annual | 3% | 4% | -1% | -3% | 1% | -4% | -5% | -4% | -2% | -4% | 2% |
| Operating return on equity—diluted | 15.2% | 11.4% | 11.2% | 12.1% | 12.4% | 11.1% | 7.6% | 9.1% | 8.7% | 9.1% | 10.9% |
| Book value per share—diluted | \$12.74 | \$14.10 | \$13.83 | \$14.25 | \$14.25 | \$15.15 | \$15.90 | \$16.28 | \$16.62 | \$16.62 | \$17.88 |
| 100-basis-point change in combined ratio | \$0.02 | \$0.02 | (\$0.03) | \$0.02 | \$0.08 | \$0.02 | \$0.02 | \$0.02 | \$0.02 | \$0.08 | \$0.09 |

¹Income before the effects of net realized investment gains/losses and the change in fair value of derivatives.
Source: Company reports and William Blair & Company estimates

- **Argo Group remains arguably least expensive name in the whole space.** We estimate a 15% increase in third-quarter operating EPS, to \$1.21 (previous estimate was \$0.84), compared with consensus of \$0.91. The year-over-year improvement is driven principally by lower catastrophe losses. There could be upside in this number, driven by even lower catastrophe losses, improvement in the Heritage business (international specialty segment), or higher favorable loss reserve development. We stress that Argo Group's earnings are the least visible of any company within our insurance coverage universe, given recent acquisitions, recent volatility, above-average catastrophe loss exposure within our universe, a continued legacy of loss reserve exposure, and the recent impact from foreign exchange. As a result, our confidence level in our estimates is the lowest within our insurance coverage universe. That said, we like Argo Group's stock because we believe the company has several opportunities for better expense and capital management as its run-off businesses wind down that should positively drive margins and returns in the business going forward. We also believe that above-average losses in the Heritage book should also dissipate over the next few quarters. The stock is also 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, some volatility in reported results, and below-average profitability. The shares trade at roughly a 30% discount to estimated third quarter 2009 book value per share of \$48.59. We believe the stock could easily trade closer to book value per share as underlying profitability improves and earnings visibility increase over the next several quarters.

We estimate a 4.4% decline in gross written premiums in the quarter, to \$456.5 million. However, growth has been difficult to predict the past few quarters, given the impact from foreign exchange and the seasonality of the Heritage business. And management has not done a good job of providing any clarity regarding expectations for Heritage's premium production. Once again, we expect the full-quarter benefit from the Heritage acquisition to be offset by the strength in the dollar versus the British pound (up over 13%). This is the first quarter that Heritage (acquisition completed in June 2008) will be fully included in both comparable periods. We expect continued pressure on the top line within the E&S segment, given rather intense competition in E&S casualty lines.

We estimate the consolidated combined ratio this quarter to be 95.4%, compared with 95.8% last quarter and 106.1% in third quarter 2008. The improvement in the combined ratio compared with the year-ago period is mainly attributed to a mix shift to the lower combined ratio Heritage business (acquisition completed in June 2008) and lower catastrophe losses. We lowered our catastrophe loss estimate for the quarter to \$7.0 million from \$22.5 million to account for the benign hurricane season in the third quarter. Our favorable loss reserve development estimate for the third quarter is \$6.5 million, up from adverse development of \$6.5 million last quarter—which included \$22 million of adverse loss reserve development from Heritage, which was partially offset by an additional \$17 million collected on business written in prior periods.

Argo Group International
Condensed Income Statement Comparison
(\$ in millions, except per share data)

| | 1Q08 | 2Q08 | 3Q08 | 4Q08 | 2008 Actual ¹ | 1Q09 | 2Q09 | 3Q09E | 4Q09E | 2009 Estimate | 2010 Estimate |
|---|----------------|----------------|----------------|----------------|-----------------------------|----------------|----------------|----------------|----------------|------------------|------------------|
| Gross premiums written | \$347 | \$398 | \$478 | \$380 | \$1,602 | \$496 | \$572 | \$457 | \$380 | \$1,904 | \$2,011 |
| <i>% change annual</i> | | | | | | 43% | 44% | -4% | 0% | 19% | 6% |
| Net premiums written | \$238 | \$293 | \$353 | \$268 | \$1,151 | \$352 | \$398 | \$331 | \$275 | \$1,356 | \$1,419 |
| <i>% change annual</i> | | | | | | 48% | 36% | -6% | 3% | 18% | 5% |
| <i>% gross premiums written</i> | 68.5% | 73.7% | 73.8% | 70.6% | 71.9% | 70.9% | 69.6% | 72.6% | 72.5% | 71.2% | 70.6% |
| Net premiums earned | \$219 | \$262 | \$323 | \$324 | \$1,127 | \$343 | \$372 | \$336 | \$336 | \$1,388 | \$1,379 |
| <i>% change annual</i> | | | | | | 57% | 42% | 4% | 4% | 23% | -1% |
| Loss and loss expense | \$132 | \$165 | \$228 | \$200 | \$725 | \$203 | \$233 | \$203 | \$203 | \$843 | \$849 |
| <i>% premiums earned</i> | 60.2% | 62.9% | 70.7% | 61.9% | 64.3% | 59.2% | 62.6% | 60.4% | 60.6% | 60.7% | 61.6% |
| Adverse loss reserve development (favorable) | (\$7) | (\$9) | (\$11) | (\$36) | (\$62) | (\$1) | \$7 | (\$7) | (\$9) | (\$9) | (\$19) |
| Catastrophe losses | \$0 | \$16 | \$60 | \$16 | \$92 | \$0 | \$5 | \$7 | \$10 | \$22 | \$43 |
| Loss ratio—ex cats and development | 63.2% | 60.1% | 55.5% | 68.0% | 61.7% | 59.4% | 59.6% | 60.3% | 60.1% | 59.8% | 59.9% |
| Acquisition costs/operating expenses | \$78 | \$95 | \$114 | \$119 | \$407 | \$127 | \$124 | \$118 | \$120 | \$489 | \$482 |
| <i>% premiums earned</i> | 35.8% | 36.4% | 35.4% | 36.9% | 36.1% | 37.1% | 33.2% | 35.0% | 35.8% | 35.2% | 34.9% |
| Underwriting income | \$9 | \$2 | (\$20) | \$4 | (\$5) | \$13 | \$16 | \$16 | \$12 | \$56 | \$48 |
| <i>% change annual</i> | | | | | | 45% | 728% | -179% | 202% | -1245% | -14% |
| <i>Combined ratio</i> | 95.9% | 99.3% | 106.1% | 98.7% | 100.4% | 96.2% | 95.8% | 95.4% | 96.4% | 95.9% | 96.5% |
| Net investment income | \$38 | \$37 | \$39 | \$37 | \$150 | \$39 | \$42 | \$42 | \$42 | \$165 | \$170 |
| <i>% change annual</i> | | | | | | 3% | 15% | 8% | 14% | 10% | 3% |
| <i>% average yield</i> | 4.2% | 3.9% | 3.9% | 3.7% | 3.9% | 3.9% | 4.1% | 4.0% | 4.0% | 4.0% | 3.9% |
| Fee income | \$0 | \$2 | \$8 | \$3 | \$14 | \$0 | \$2 | \$2 | \$2 | \$5 | \$5 |
| Interest expense and other² | \$7 | \$10 | \$15 | \$6 | \$37 | \$9 | \$28 | \$11 | \$11 | \$59 | \$35 |
| <i>% change annual</i> | | | | | | 31% | 194% | -28% | 93% | 58% | -41% |
| Pretax operating income | \$40 | \$31 | \$12 | \$39 | \$121 | \$43 | \$32 | \$48 | \$45 | \$167 | \$188 |
| <i>% change annual</i> | | | | | | 8% | 3% | 298% | 16% | 38% | 12% |
| Net realized investment gains/(losses) | \$1 | (\$1) | (\$18) | (\$17) | (\$35) | (\$12) | (\$9) | \$0 | \$0 | (\$21) | \$0 |
| Income before taxes | \$41 | \$30 | (\$6) | \$22 | \$86 | \$31 | \$22 | \$48 | \$45 | \$146 | \$188 |
| <i>% change annual</i> | | | | | | -24% | -24% | -853% | 105% | 70% | 28% |
| Income tax expense | \$4 | \$7 | \$2 | \$10 | \$24 | \$4 | \$1 | \$11 | \$9 | \$24 | \$40 |
| <i>Effective tax rate</i> | 10.7% | 22.2% | -37.7% | 46.4% | 27.2% | 14.0% | 2.7% | 22.0% | 20.0% | 16.7% | 21.5% |
| Net income | \$37 | \$23 | (\$9) | \$12 | \$63 | \$27 | \$22 | \$37 | \$36 | \$122 | \$148 |
| <i>% change annual</i> | | | | | | -27% | -5% | -527% | 206% | 94% | 21% |
| Operating income³ | \$36 | \$24 | \$3 | \$23 | \$86 | \$35 | \$39 | \$37 | \$36 | \$147 | \$148 |
| <i>% change annual</i> | | | | | | -4% | 63% | 1070% | 53% | 70% | 1% |
| Diluted operating EPS | \$1.17 | \$0.77 | \$0.10 | \$0.76 | \$2.81 | \$1.13 | \$1.26 | \$1.21 | \$1.16 | \$4.77 | \$4.80 |
| <i>% change annual</i> | | | | | | -4% | 63% | 1070% | 52% | 69% | 1% |
| Average diluted shares | 30.8 | 30.8 | 30.6 | 30.7 | 30.7 | 30.7 | 30.8 | 30.8 | 30.8 | 30.8 | 30.8 |
| <i>% change annual</i> | | | | | | 0% | 0% | 1% | 0% | 0% | 0% |
| Operating return on equity—diluted | 10.3% | 6.8% | 0.9% | 6.9% | 6.2% | 10.1% | 10.9% | 10.1% | 9.4% | 10.1% | 9.2% |
| Book value per share—diluted | \$46.36 | \$45.85 | \$44.10 | \$44.18 | \$44.18 | \$45.16 | \$47.51 | \$48.59 | \$49.75 | \$49.75 | \$54.55 |

¹Given Argonaut Group's reverse merger with PXRE Group in August 2007, historical consolidated results are distorted for comparative purposes.

²Interest expense and other includes interest expense, fee-based operation expenses, foreign exchange gains/losses, and other noninsurance company expenses.

³Excludes realized investment gains/losses.

Source: Company reports and William Blair & Company estimates

Remaining Companies in Coverage List:

- **AMERISAFE, well managed and executing well, but more relative value in other names.** We estimate a 21% decline in third-quarter operating EPS, based on a full converted share count, to \$0.59, compared with consensus of \$0.54. We expect favorable loss reserve development to continue to have a positive, yet smaller impact on underwriting margins, with our third-quarter estimate at \$3.5 million, compared with \$6.6 million third quarter 2008 and \$5.2 million last quarter. We believe the absolute level of favorable development will dissipate over the next few quarters, but estimating the impact on a quarterly basis is a challenge. We estimate the combined ratio this quarter to be 84.8%, compared with 83.3% last quarter and 79.4% in third quarter 2008. We estimate an 8% decline in gross written premiums during the quarter, to \$69.7 million. The company has seen good new business growth from clients moving from AIG, with new accounts totaling \$15.4 million in premium between mid-September 2008 and the end of second quarter 2009. However, we anticipate that the negative impact on payroll growth (main driver of premiums) from the weak economy, coupled with four years of price declines, will weigh on top-line growth over the next few quarters. If pricing improvements materialize, we also believe that workers' compensation underwriters have less flexibility in managing pricing changes, given the

heavy regulation of the business and payroll growth will not improve materially any time over the next 4 to 6 quarters. The shares trade at about 1.11 times estimated third-quarter diluted book per share of \$15.43, 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.

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

| | 1Q08 | 2Q08 | 3Q08 | 4Q08 | 2008 Actual | 1Q09 | 2Q09 | 3Q09E | 4Q09E | 2009 Estimate | 2010 Estimate |
|---|-----------------|-----------------|-----------------|-----------------|------------------|-----------------|-----------------|-----------------|-----------------|------------------|------------------|
| Gross premiums written | \$80,977 | \$85,995 | \$75,767 | \$65,102 | \$307,841 | \$79,429 | \$72,537 | \$69,706 | \$60,219 | \$281,891 | \$298,804 |
| % change annual | -11% | -9% | -7% | 5% | -6% | -2% | -16% | -8% | -8% | -8% | 6% |
| Net premiums written | \$76,187 | \$81,329 | \$71,193 | \$59,482 | \$288,191 | \$74,235 | \$67,667 | \$65,523 | \$55,101 | \$262,526 | \$279,382 |
| % change annual | -11% | -9% | -6% | 5% | -6% | -3% | -17% | -8% | -7% | -9% | 6% |
| % gross premiums written | 94.1% | 94.6% | 94.0% | 91.4% | 93.6% | 93.5% | 93.3% | 94.0% | 91.5% | 93.1% | 93.5% |
| Net premiums earned | \$74,300 | \$72,143 | \$71,284 | \$71,766 | \$289,493 | \$70,001 | \$65,792 | \$67,352 | \$66,160 | \$269,305 | \$270,954 |
| % change annual | -2% | -6% | -10% | -3% | -6% | -6% | -9% | -6% | -8% | -7% | 1% |
| Loss and loss expense | \$49,928 | \$47,317 | \$41,972 | \$37,172 | \$176,389 | \$47,070 | \$40,219 | \$43,105 | \$41,681 | \$172,075 | \$184,791 |
| % premiums earned | 67.2% | 65.6% | 58.9% | 51.8% | 60.9% | 67.2% | 61.1% | 64.0% | 63.0% | 63.9% | 68.2% |
| Reserve development | \$1,700 | \$2,800 | \$6,600 | \$9,300 | \$20,400 | \$1,200 | \$5,200 | \$3,500 | \$4,000 | \$13,900 | \$4,000 |
| % premiums earned | 2.3% | 3.9% | 9.3% | 13.0% | 7.0% | 1.7% | 7.9% | 5.2% | 6.0% | 5.2% | 1.5% |
| Total underwriting expenses | \$14,514 | \$14,149 | \$14,474 | \$12,799 | \$55,936 | \$14,768 | \$14,475 | \$13,841 | \$13,927 | \$57,011 | \$56,358 |
| Expense ratio | 19.5% | 19.6% | 20.3% | 17.8% | 19.3% | 21.1% | 22.0% | 20.6% | 21.1% | 21.2% | 20.8% |
| Policyholder dividends | \$316 | \$122 | \$125 | \$2,941 | \$3,504 | \$181 | \$141 | \$162 | \$132 | \$616 | \$542 |
| Policyholder dividend ratio | 0.4% | 0.2% | 0.2% | 4.1% | 1.2% | 0.3% | 0.2% | 0.2% | 0.2% | 0.2% | 0.2% |
| Underwriting income | \$9,542 | \$10,555 | \$14,713 | \$18,854 | \$53,664 | \$7,982 | \$10,957 | \$10,244 | \$10,420 | \$39,603 | \$29,263 |
| % change annual | 67% | 18% | 71% | -6% | 24% | -16% | 4% | -30% | -45% | -26% | -26% |
| Combined ratio | 87.2% | 85.4% | 79.4% | 73.7% | 81.5% | 88.6% | 83.3% | 84.8% | 84.3% | 85.3% | 89.2% |
| Fees and other income | \$141 | \$229 | \$200 | \$172 | \$742 | \$136 | \$705 | \$200 | \$200 | \$1,241 | \$950 |
| % change annual | 1% | 66% | -69% | 23% | -30% | -4% | 208% | 0% | 16% | 67% | -23% |
| Net investment income | \$7,817 | \$7,405 | \$7,712 | \$8,064 | \$30,998 | \$7,372 | \$6,982 | \$7,065 | \$7,237 | \$28,656 | \$32,360 |
| % change annual | 13% | 0% | -3% | 2% | 3% | -6% | -6% | -8% | -10% | -8% | 13% |
| % of average invested assets | 4.1% | 3.8% | 4.0% | 4.1% | 4.0% | 3.7% | 3.5% | 3.5% | 3.5% | 3.5% | 3.7% |
| Interest expense | \$769 | \$657 | \$654 | \$380 | \$2,460 | \$611 | \$383 | \$575 | \$575 | \$2,144 | \$2,000 |
| Pretax operating income | \$16,731 | \$17,532 | \$21,971 | \$26,710 | \$82,944 | \$14,879 | \$18,261 | \$16,934 | \$17,282 | \$67,356 | \$60,574 |
| % change annual | 41% | 12% | 35% | -2% | 17% | -11% | 4% | -23% | -35% | -19% | -10% |
| Net realized investment gains/(losses) | \$8 | \$53 | (\$2,921) | (\$15,996) | (\$18,856) | \$26 | \$17 | \$0 | \$0 | \$43 | \$0 |
| Income before taxes | \$16,739 | \$17,585 | \$19,050 | \$10,714 | \$64,088 | \$14,905 | \$18,278 | \$16,934 | \$17,282 | \$67,399 | \$60,574 |
| % change annual | 41% | 13% | 17% | -61% | -10% | -11% | 4% | -11% | 61% | 5% | -10% |
| Income tax expense | \$4,816 | \$4,758 | \$5,691 | \$4,977 | \$20,242 | \$3,843 | \$4,577 | \$4,911 | \$5,012 | \$18,343 | \$17,566 |
| Effective tax rate | 28.8% | 27.1% | 29.9% | 46.5% | 31.6% | 25.8% | 25.0% | 29.0% | 29.0% | 27.2% | 29.0% |
| Net income before preferred dividends | \$11,923 | \$12,827 | \$13,359 | \$5,737 | \$43,846 | \$11,062 | \$13,701 | \$12,023 | \$12,270 | \$49,057 | \$43,007 |
| % change annual | 42% | 13% | 13% | -69% | -13% | -7% | 7% | -10% | 114% | 12% | -12% |
| 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 | \$12,023 | \$12,270 | \$49,057 | \$43,007 |
| % change annual | 42% | 13% | 13% | -69% | -13% | -7% | 7% | -10% | 114% | 12% | -12% |
| Operating income¹ | \$11,918 | \$12,793 | \$15,258 | \$19,094 | \$59,062 | \$11,045 | \$13,690 | \$12,023 | \$12,270 | \$49,029 | \$43,007 |
| % change annual | 42% | 13% | 30% | 3% | 18% | -7% | 7% | -21% | -36% | -17% | -12% |
| Diluted operating EPS | \$0.59 | \$0.63 | \$0.75 | \$0.94 | \$2.90 | \$0.54 | \$0.67 | \$0.59 | \$0.60 | \$2.40 | \$2.10 |
| % change annual | 41% | 13% | 29% | 2% | 17% | -8% | 6% | -21% | -36% | -17% | -13% |
| Average diluted shares ² | 20,234 | 20,306 | 20,422 | 20,420 | 20,346 | 20,450 | 20,457 | 20,435 | 20,440 | 20,446 | 20,500 |
| % change annual | 0% | 0% | 1% | 1% | 0% | 1% | 1% | 0% | 0% | 0% | 0% |
| Operating return on equity—diluted | 20.0% | 20.6% | 23.4% | 28.0% | 23.1% | 15.6% | 18.6% | 15.5% | 15.3% | 16.2% | 12.3% |
| Book value per share—diluted | \$12.01 | \$12.55 | \$13.07 | \$13.63 | \$13.63 | \$14.04 | \$14.82 | \$15.43 | \$16.03 | \$16.03 | \$18.08 |
| 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 | \$0.10 | \$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

- **HCC Insurance Holdings, quality assets at attractive absolute valuation.** We estimate a 23% increase in third-quarter operating EPS, to \$0.75, compared with consensus of \$0.71. The year-over-year increase is being driven by large catastrophe losses in the year-ago period related to Hurricanes Gustav and Ike. We estimate a 5% increase in net written premiums in the quarter to \$520 million. We anticipate that third-quarter growth will be driven by the company's diversified financial products line, which includes D&O liability coverage (45% of total) followed by the London market account (4% of total). The company has been benefiting from a flight-to-quality in the D&O business as one of only two publicly traded underwriters with a double-A rating by a major rating agency, and prices are up in catastrophe exposed property and offshore energy (London market account business). In addition, medical stop-loss pricing as of the end of the second quarter, according to management, continued to run modestly in excess of claims inflation, which is unique within the broader industry and overall should continue to have a positive impact on top-line growth within Group Life, A&H.

We estimate the combined ratio this quarter to be 84.8%, compared with 83.8% last quarter, and 88.0% third quarter 2008—which include hurricane losses from Gustav and Ike. Our estimate for favorable loss reserve development in the quarter is \$7.5 million, compared with favorable development of \$16 million last quarter and \$4.7 million of adverse development first quarter 2009. While we believe favorable loss reserve development is likely to continue in the near term, given favorable loss reserve development for accident years 2003 to 2007, some uncertainty still surrounds possible increases in accident-year loss ratios for economically sensitive lines—D&O, credit, and surety, despite current rate increases in these lines.

We view valuation as attractive on an absolute basis and view HCC as having a quality collection of assets that would be attractive to a broad group of acquirers. The shares trade at roughly 1.07 times estimated third quarter 2009 book value per share of \$25.72, which we believe is 25% to 35% below fair value in a normal market environment, although modestly above the overall commercial lines group currently.

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

| | 1Q08 | 2Q08 | 3Q08 | 4Q08 | 2008 Actual | 1Q09 | 2Q09 | 3Q09E | 4Q09E | 2009 Estimate | 2010 Estimate |
|---|------------------|------------------|------------------|------------------|--------------------|------------------|------------------|------------------|------------------|--------------------|--------------------|
| Gross written premium | \$582,999 | \$691,593 | \$612,964 | \$611,207 | \$2,498,763 | \$602,387 | \$681,317 | \$634,021 | \$645,193 | \$2,562,918 | \$2,759,106 |
| % change annual | -3% | 4% | 3% | 3% | 2% | 3% | -1% | 3% | 6% | 3% | 8% |
| Net written premium | \$493,647 | \$567,150 | \$495,585 | \$504,236 | \$2,060,618 | \$491,250 | \$543,352 | \$519,605 | \$534,357 | \$2,088,564 | \$2,256,509 |
| % change annual | -1% | 6% | 6% | 4% | 4% | 0% | -4% | 5% | 6% | 1% | 8% |
| % gross written premium | 85% | 82% | 81% | 82% | 82% | 82% | 80% | 82% | 83% | 81% | 82% |
| Premiums earned | \$493,546 | \$506,610 | \$504,972 | \$502,646 | \$2,007,774 | \$502,388 | \$501,978 | \$504,108 | \$505,876 | \$2,014,350 | \$2,122,537 |
| % change annual | -1% | 2% | 2% | 0% | 1% | 2% | -1% | 0% | 1% | 0% | 5% |
| Losses and LAE incurred | \$293,026 | \$302,901 | \$324,506 | \$291,440 | \$1,211,873 | \$315,566 | \$292,570 | \$301,457 | \$303,020 | \$1,212,612 | \$1,273,522 |
| % premiums earned | 59.4% | 59.8% | 64.3% | 58.0% | 60.4% | 62.8% | 58.3% | 59.8% | 59.9% | 60.2% | 60.0% |
| Favorable/(unfavorable) reserve development | \$5,100 | \$9,300 | \$44,000 | \$24,000 | \$82,400 | (\$4,700) | \$16,000 | \$7,500 | \$7,500 | \$26,300 | \$15,000 |
| % premiums earned | 1.0% | 1.8% | 8.7% | 4.8% | 4.1% | -0.9% | 3.2% | 1.5% | 1.5% | 1.3% | 0.7% |
| Policy acquisition costs | \$92,268 | \$95,845 | \$96,582 | \$96,746 | \$381,441 | \$88,692 | \$90,248 | \$93,260 | \$93,587 | \$365,787 | \$386,302 |
| % premiums earned | 18.7% | 18.9% | 19.1% | 19.2% | 19.0% | 17.7% | 18.0% | 18.5% | 18.5% | 18.2% | 18.2% |
| Underwriting expense | \$59,204 | \$57,514 | \$57,702 | \$59,089 | \$233,509 | \$68,998 | \$61,526 | \$61,517 | \$58,364 | \$250,405 | \$256,314 |
| % of operating revenue less NII | 11.4% | 10.5% | 10.5% | 11.2% | 10.9% | 12.4% | 11.5% | 11.5% | 11.0% | 11.6% | 11.4% |
| Expense ratio | 24.3% | 24.3% | 23.7% | 27.6% | 25.0% | 24.5% | 25.5% | 25.0% | 24.7% | 24.9% | 24.7% |
| Underwriting income | \$49,048 | \$50,350 | \$26,182 | \$55,371 | \$180,951 | \$29,132 | \$57,634 | \$47,874 | \$50,905 | \$185,545 | \$206,399 |
| % change annual | -3% | -4% | -56% | 81% | -6% | -41% | 14% | 83% | -8% | 3% | 11% |
| Underwriting margin | 23.7% | 23.1% | 17.9% | 19.8% | 21.1% | 19.9% | 23.6% | 22.7% | 23.0% | 22.3% | 22.5% |
| Combined ratio | 83.7% | 84.1% | 88.0% | 85.6% | 85.3% | 87.3% | 83.8% | 84.8% | 84.6% | 85.1% | 84.7% |
| Fees and commissions | \$30,999 | \$30,764 | \$37,795 | \$25,643 | \$125,201 | \$30,294 | \$26,132 | \$26,457 | \$23,079 | \$105,961 | \$105,961 |
| % change annual | -4% | -1% | -12% | -25% | -11% | -2% | -15% | -10% | -10% | -15% | 0% |
| Noninsurance company expenses | \$31,540 | \$30,253 | \$34,606 | \$17,105 | \$113,503 | \$34,605 | \$23,770 | \$28,750 | \$27,000 | \$114,125 | \$117,500 |
| % change annual | 8% | 11% | -1% | -61% | -16% | 10% | -21% | -17% | 58% | 1% | 3% |
| Fee-based income | (\$541) | \$511 | \$3,189 | \$8,538 | \$11,698 | (\$4,311) | \$2,362 | (\$2,294) | (\$3,921) | (\$8,163) | (\$11,539) |
| % change annual | -119% | -87% | -59% | -184% | 167% | 696% | 362% | -172% | -146% | -170% | 41% |
| Fee-based margin | -2.1% | 1.2% | 7.5% | 34.9% | 8.7% | -8.1% | 7.5% | -7.8% | -15.0% | -5.8% | -9.6% |
| Net investment income | \$47,621 | \$47,249 | \$35,962 | \$33,919 | \$164,751 | \$45,218 | \$48,411 | \$48,988 | \$49,596 | \$192,213 | \$198,930 |
| % change annual | -4% | -3% | -28% | -42% | -20% | -5% | 2% | 36% | 46% | 17% | 3% |
| Other income | (\$4,946) | \$10,947 | \$4,828 | (\$1,191) | \$9,638 | \$22,896 | \$5,523 | \$3,000 | \$3,000 | \$34,419 | \$14,750 |
| Total operating revenues | \$567,220 | \$595,570 | \$583,557 | \$561,017 | \$2,307,364 | \$600,796 | \$582,044 | \$582,553 | \$581,551 | \$2,346,944 | \$2,442,178 |
| % change annual | -5% | 0% | 0% | -7% | -3% | 6% | -2% | 0% | 4% | 2% | 4% |
| Pretax operating margin | 21.0% | 22.3% | 14.4% | 17.8% | 18.9% | 20.4% | 22.9% | 21.1% | 21.1% | 21.4% | 20.8% |
| Interest expense | \$3,959 | \$4,826 | \$3,750 | \$4,771 | \$17,306 | \$4,639 | \$3,628 | \$3,650 | \$3,650 | \$15,567 | \$18,000 |
| Income before income taxes | \$118,931 | \$132,764 | \$83,779 | \$99,820 | \$435,294 | \$122,843 | \$133,164 | \$122,669 | \$122,930 | \$501,606 | \$508,040 |
| Provision for income taxes | \$37,482 | \$41,089 | \$24,726 | \$27,543 | \$130,840 | \$39,673 | \$41,579 | \$38,641 | \$38,723 | \$158,616 | \$157,493 |
| Effective tax rate | 31.5% | 30.9% | 29.5% | 27.6% | 30.1% | 32.3% | 31.2% | 31.5% | 31.5% | 31.6% | 31.0% |
| Net income | \$81,449 | \$91,675 | \$59,053 | \$72,277 | \$304,454 | \$83,170 | \$91,585 | \$84,028 | \$84,207 | \$342,990 | \$350,548 |
| % change annual | -16% | -9% | -40% | -27% | -23% | 2% | 0% | 42% | 17% | 13% | 2% |
| Operating income after tax ¹ | \$81,340 | \$92,793 | \$70,258 | \$78,225 | \$322,616 | \$83,208 | \$92,175 | \$84,028 | \$84,207 | \$343,618 | \$350,548 |
| % change annual | -16% | -8% | -28% | -14% | -17% | 2% | -1% | 20% | 8% | 7% | 2% |
| Operating earnings per share | \$0.70 | \$0.80 | \$0.61 | \$0.69 | \$2.79 | \$0.73 | \$0.82 | \$0.75 | \$0.75 | \$3.05 | \$3.10 |
| % change annual | -16% | -7% | -28% | -11% | -15% | 5% | 2% | 23% | 9% | 9% | 2% |
| Average diluted shares | 116,372 | 116,075 | 115,418 | 114,111 | 115,494 | 113,300 | 112,500 | 112,500 | 112,750 | 112,763 | 113,000 |
| Return on equity—operating basis | 13.1% | 14.6% | 10.8% | 11.9% | 12.6% | 12.5% | 13.4% | 11.8% | 11.5% | 12.3% | 11.1% |
| Book value per share—diluted | \$21.67 | \$22.09 | \$22.85 | \$23.14 | \$23.14 | \$23.87 | \$24.97 | \$25.72 | \$26.41 | \$26.41 | \$29.45 |

¹Income before net realized capital gains/losses and excluding discontinued operations.
Source: Company reports and William Blair & Company L.L.C. estimates

- Aon Corporation, preferred name within insurance brokerage space.** We view Aon's stock as more compelling recently, given an improvement in relative valuation, consistently superior execution, and the company's strong competitive position coming out of an extended period of transformation. We also believe Aon will once again manage capital more aggressively as credit markets continue to stabilize. We estimate a 4% decline in third-quarter adjusted EPS from continuing operations to \$0.66 (excluding nonrecurring gains/losses and restructuring expense), compared with consensus estimate of \$0.66. The stronger dollar will continue to be a drag on results (\$0.04 last quarter). The year-over-year decline in EPS growth is driven by a stronger dollar and lower net investment income, given the massive decline in short-term interest rates.

We estimate 0.0%-2.0% organic revenue growth within insurance brokerage (about 85% of earnings), which could mark the 17th consecutive quarter of avoiding negative organic growth—compared with 0.0% last quarter (the first quarter in four years that the company did not achieve positive organic growth), and 2.0% for each of the 2008 quarters. The global recession is clearly having an adverse impact on organic growth, although we do not expect business conditions to be significantly worse in the third quarter as the pricing environment has not materially changed from

last quarter (about two-thirds of insurance brokerage revenue is commission based, and insurance brokerage contributes about 85% of total company profits).

We expect the adjusted insurance brokerage operating margin to increase roughly 170 basis points to 18.5% in the second quarter 2009, compared with the year-ago period. The third quarter is the insurance brokerage's seasonally weakest margin quarter. We expect margins to move higher, despite possible reductions in net investment income and foreign exchange and pension expense headwinds, due to restructuring savings and a higher margin contribution from the Benfield acquisition. The benefits from restructuring should continue through 2010, but the major benefits from the 2007 program will occur this year. In the second quarter, the adjusted operating margin was up 130 basis points to 19.6%, and in the first quarter the adjusted operating margin was up 100 basis points compared to first quarter 2008. The shares currently trade at 12.1 times our 2010 EPS estimate of \$3.40; we view 10 to 12 times as an attractive entry point. Our main concerns include economic pressures and a more-sober outlook for pricing, both putting pressure on organic growth. That said, we believe the stock could trade closer to 15 to 17 times if pricing improvements develop more favorably than expected over the next few quarters and the economy stabilizes into 2010. At worst, we would expect Aon to maintain a double-digit 12-month forward P/E multiple without a dramatic drop in organic growth over the next few quarters, which we do not expect.

Aon Corporation
Condensed Income Statement Comparison
(*\$ in millions, except per share data*)

| | 1Q08 | 2Q08 | 3Q08 | 4Q08 | 2008 Actual | 1Q09 | 2Q09 | 3Q09E | 4Q09E | 2009 Estimate | 2010 Estimate |
|---|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Revenue: | | | | | | | | | | | |
| Insurance brokerage | \$1,566 | \$1,610 | \$1,473 | \$1,581 | \$6,230 | \$1,550 | \$1,578 | \$1,490 | \$1,678 | \$6,296 | \$6,590 |
| % change | 10% | 8% | 4% | -3% | 5% | -1% | -2% | 1% | 6% | 1% | 5% |
| % organic growth | 2% | 2% | 2% | 2% | 2% | 1% | 0% | 1% | 2% | 1% | 4% |
| Americas | \$493 | \$588 | \$557 | \$642 | \$2,280 | \$477 | \$574 | \$546 | \$648 | \$2,245 | \$2,335 |
| % change | 3% | 1% | 2% | -1% | 1% | -3% | -2% | -2% | 1% | -2% | 4% |
| % organic growth | 1% | -1% | 1% | 3% | 0% | 2% | 3% | 1% | 2% | 2% | 4% |
| International | \$766 | \$725 | \$616 | \$648 | \$2,755 | \$648 | \$613 | \$554 | \$661 | \$2,476 | \$2,569 |
| % change | 15% | 14% | 7% | -9% | 6% | -15% | -15% | -10% | 2% | -10% | 4% |
| % organic growth | 2% | 2% | 2% | 2% | 2% | 1% | 0% | 1% | 2% | 1% | 4% |
| Reinsurance brokerage | \$256 | \$248 | \$252 | \$247 | \$1,003 | \$395 | \$372 | \$378 | \$358 | \$1,503 | \$1,608 |
| % change | 7% | 13% | 9% | 18% | 11% | 54% | 50% | 50% | 45% | 50% | 7% |
| % organic growth | 1% | 2% | 1% | 2% | 1% | 1% | 4% | 2% | 3% | 2% | 6% |
| Net investment income | \$51 | \$49 | \$48 | \$44 | \$192 | \$30 | \$19 | \$12 | \$10 | \$71 | \$78 |
| % change | 13% | -8% | -14% | -14% | -6% | -41% | -61% | -75% | -77% | -63% | 9% |
| Consulting services | \$342 | \$335 | \$335 | \$341 | \$1,353 | \$308 | \$300 | \$307 | \$336 | \$1,251 | \$1,294 |
| % change | 4% | 5% | 3% | -8% | 1% | -10% | -10% | -8% | -2% | -8% | 3% |
| % organic growth | 0% | 2% | 6% | 3% | 3% | 2% | -1% | 2% | 2% | 1% | 4% |
| Total operating segment revenue | \$1,908 | \$1,945 | \$1,808 | \$1,922 | \$7,583 | \$1,858 | \$1,878 | \$1,798 | \$2,013 | \$7,547 | \$7,884 |
| % change | 9% | 8% | 4% | -4% | 4% | -3% | -3% | -1% | 5% | 0% | 4% |
| Corporate and other | \$5 | \$17 | \$41 | \$6 | \$69 | \$1 | \$13 | \$5 | \$5 | \$24 | \$26 |
| Intersegment revenue | (\$9) | (\$7) | (\$4) | (\$5) | (\$25) | (\$6) | (\$6) | (\$7) | (\$7) | (\$25) | (\$28) |
| Total revenue | \$1,904 | \$1,955 | \$1,845 | \$1,923 | \$7,627 | \$1,853 | \$1,885 | \$1,796 | \$2,012 | \$7,546 | \$7,882 |
| % change | 8% | 7% | 6% | -4% | 4% | -3% | -4% | -3% | 5% | -1% | 4% |
| Pretax income from continuing operations¹ | | | | | | | | | | | |
| Insurance brokerage | \$309 | \$294 | \$247 | \$314 | \$1,164 | \$321 | \$309 | \$276 | \$347 | \$1,253 | \$1,373 |
| % change | 17% | 12% | 1% | 5% | 9% | 4% | 5% | 12% | 11% | 8% | 10% |
| % total revenue | 19.7% | 18.3% | 16.8% | 19.9% | 18.7% | 20.7% | 19.6% | 18.5% | 20.7% | 20.1% | 21.1% |
| Consulting services | \$66 | \$47 | \$53 | \$65 | \$231 | \$52 | \$45 | \$45 | \$52 | \$194 | \$207 |
| % change | 35% | -2% | 36% | 2% | 16% | -21% | -4% | -16% | -20% | -16% | 7% |
| % total revenue | 19.3% | 14.0% | 15.8% | 19.1% | 17.1% | 16.9% | 15.0% | 14.5% | 15.5% | 15.5% | 16.0% |
| Total operating segment revenue | \$375 | \$341 | \$300 | \$379 | \$1,395 | \$373 | \$354 | \$320 | \$399 | \$1,447 | \$1,580 |
| % change | 20% | 10% | 6% | 4% | 10% | -1% | 4% | 7% | 5% | 4% | 9% |
| % total revenue | 19.7% | 17.4% | 16.3% | 19.7% | 18.3% | 20.1% | 18.8% | 17.8% | 19.8% | 19.2% | 20.0% |
| Corporate and other | (\$48) | (\$51) | (\$22) | (\$54) | (\$175) | (\$59) | (\$41) | (\$55) | (\$53) | (\$208) | (\$208) |
| Total pretax income | \$327 | \$290 | \$278 | \$325 | \$1,220 | \$314 | \$313 | \$265 | \$347 | \$1,239 | \$1,372 |
| % change | 24% | 7% | 16% | 5% | 13% | -4% | 8% | -5% | 7% | 2% | 11% |
| % total revenue | 21.6% | 18.6% | 19.5% | 21.1% | 20.2% | 20.7% | 20.1% | 17.9% | 20.8% | 19.9% | 21.1% |
| Provision for income taxes | \$102 | \$76 | \$78 | \$93 | \$346 | \$108 | \$57 | \$74 | \$97 | \$336 | \$398 |
| Effective tax rate | 31.2% | 26.2% | 28.1% | 28.6% | 28.4% | 31.5% | 27.1% | 28.0% | 28.0% | 28.9% | 29.0% |
| Adjusted operating earnings | \$225 | \$214 | \$200 | \$232 | \$874 | \$230 | \$147 | \$191 | \$250 | \$818 | \$974 |
| % change | 22% | 17% | 19% | 4% | 15% | -3% | 3% | -4% | 8% | 1% | 11% |
| Operating earnings per share¹ | \$0.70 | \$0.70 | \$0.69 | \$0.81 | \$2.90 | \$0.76 | \$0.76 | \$0.66 | \$0.86 | \$3.05 | \$3.40 |
| % change | 23% | 23% | 32% | 19% | 24% | 8% | 9% | -4% | 7% | 5% | 12% |
| Average diluted shares | 319.8 | 305.3 | 290.3 | 288.1 | 300.9 | 288.8 | 289.1 | 289.0 | 289.0 | 289.0 | 286.5 |
| % change | -1% | -5% | -10% | -11% | -7% | -10% | -5% | 0% | 0% | -4% | -1% |

¹Excludes restructuring charges, other nonrecurring gains/losses, and discontinued operations
Source: Company reports and William Blair & Company estimates

- **Marsh & McLennan Companies, Inc.** We estimate a 10% increase in third-quarter adjusted EPS, to \$0.31, compared with consensus estimate of \$0.26. The growth in earnings is mainly attributed to an improvement in expense management and better execution at Guy Carpenter (reinsurance brokerage) compared with a year ago. We estimate 2.0% organic growth in risk and insurance services, compared with 2% organic growth last quarter, and negative 1% organic growth in the year-ago period. We estimate 8% organic growth for Guy Carpenter, coming off of outstanding first and second quarters in 2009 with 10% and 11% organic growth, respectively, and up against a favorable comparison after a very disappointing 2008. We estimate 4.0% organic growth within the company's international brokerage operations and a 2.0% decline in organic growth within the United States and Canada.

Despite headwinds, we expect the adjusted insurance brokerage operating margin to increase roughly 920 basis points, to 14.5%—up against a terrible third quarter 2008, and compared with 20.2% last quarter. The company's third-quarter operating margin is also typically the seasonally weakest margin quarter for insurance brokerage. The adjusted insurance brokerage margins year-to-date exceeded our estimates, as expense management continues to be better than expected under new management. On its second-quarter conference call management raised its 2009 adjusted operating margin guidance for insurance brokerage to 18% from 17%, versus 13.3% in 2008. Our 2009 insurance brokerage margin estimate is nearly 20%.

We expect negative 6% organic growth in consulting in the third quarter and 10% and 15% declines in revenue for the core Mercer business and the specialty consulting Oliver Wyman business, respectively. We estimate a 240-basis-point decline in the adjusted operating margin to 9.5% compared with the year-ago period given revenue pressure, and this business should be able to produce midteens percentage operating margins over time, in our view. The shares trade at 12.8 times our 2010 EPS estimate of \$1.90, and we view 10 to 12 times an attractive entry point in this environment. We favor Aon over Marsh & McLennan in the near term at the same valuation, given less economic sensitivity and higher conviction regarding Aon's execution ability.

Marsh & McLennan Companies, Inc.
Condensed Income Statement Comparison
(\$ in millions, except per share data)

| | 1Q08 | 2Q08 | 3Q08 | 4Q08 | 2008 Actual | 1Q09 | 2Q09 | 3Q09E | 4Q09E | 2009 Estimate | 2010 Estimate |
|---|----------------|----------------|----------------|----------------|-----------------|----------------|----------------|----------------|----------------|------------------|------------------|
| Operating revenue: | | | | | | | | | | | |
| Risk & Insurance Services | \$1,500 | \$1,415 | \$1,313 | \$1,276 | \$5,504 | \$1,372 | \$1,343 | \$1,226 | \$1,268 | \$5,210 | \$5,447 |
| % change annual | 5% | 6% | 4% | -6% | 2% | -9% | -5% | -7% | -1% | -5% | 5% |
| % organic growth | -4% | 1% | -1% | 1% | 0% | -1% | 2% | 2% | 2% | 2% | 5% |
| Risk Consulting & Technology | \$257 | \$266 | \$254 | \$201 | \$978 | \$187 | \$161 | \$203 | \$171 | \$722 | \$722 |
| % change annual | 10% | 7% | -2% | -19% | -1% | -27% | -39% | -20% | -15% | -26% | 0% |
| % organic growth | 3% | 6% | -5% | -16% | -3% | -8% | -20% | -5% | -5% | -10% | 0% |
| Mercer Consulting | \$1,295 | \$1,374 | \$1,328 | \$1,199 | \$5,196 | \$1,083 | \$1,143 | \$1,176 | \$1,187 | \$4,590 | \$4,719 |
| % change annual | 15% | 13% | 9% | -9% | 6% | -16% | -17% | -11% | -1% | -12% | 3% |
| % organic growth | 8% | 7% | 6% | -3% | 4% | -7% | -9% | -6% | 0% | -5% | 3% |
| Total operating revenue | \$3,052 | \$3,055 | \$2,895 | \$2,676 | \$11,678 | \$2,642 | \$2,647 | \$2,606 | \$2,627 | \$10,522 | \$10,889 |
| % change annual | 9% | 9% | 6% | -9% | 4% | -13% | -13% | -10% | -2% | -10% | 3% |
| Corporate eliminations | (\$13) | (\$22) | (\$19) | (\$14) | (\$68) | (\$13) | (\$18) | (\$20) | (\$20) | (\$71) | (\$80) |
| % change annual | -63% | -4% | -17% | 8% | -28% | 0% | -18% | 5% | 43% | 4% | 13% |
| Total revenue | \$3,039 | \$3,033 | \$2,876 | \$2,662 | \$11,610 | \$2,629 | \$2,629 | \$2,586 | \$2,607 | \$10,451 | \$10,809 |
| % change annual | 10% | 9% | 6% | -9% | 4% | -13% | -13% | -10% | -2% | -10% | 3% |
| Operating income: | | | | | | | | | | | |
| Risk & Insurance Services | \$264 | \$207 | \$69 | \$189 | \$729 | \$343 | \$271 | \$178 | \$235 | \$1,026 | \$1,143 |
| % change annual | 6% | 80% | 1280% | 105% | 58% | 30% | 31% | 158% | 24% | 41% | 11% |
| % operating segment revenue | 17.6% | 14.6% | 5.3% | 14.8% | 13.2% | 25.0% | 20.2% | 14.5% | 18.5% | 19.7% | 21.0% |
| Risk Consulting & Technology | \$16 | \$31 | \$28 | \$11 | \$86 | \$12 | \$7 | \$16 | \$14 | \$49 | \$72 |
| % change annual | -33% | 3% | -3% | -27% | -12% | -25% | -77% | -42% | 24% | -43% | 48% |
| % operating segment revenue | 6.2% | 11.7% | 11.0% | 5.5% | 8.8% | 6.4% | 4.3% | 8.0% | 8.0% | 6.8% | 10.0% |
| Mercer Consulting | \$151 | \$165 | \$158 | \$121 | \$595 | \$74 | \$101 | \$112 | \$131 | \$417 | \$549 |
| % change annual | 7% | 2% | 6% | -25% | -3% | -51% | -39% | -29% | 8% | -30% | 32% |
| % operating segment revenue | 11.7% | 12.0% | 11.9% | 10.1% | 11.5% | 6.8% | 8.8% | 9.5% | 11.0% | 9.1% | 11.6% |
| Total operating income | \$431 | \$403 | \$255 | \$321 | \$1,410 | \$429 | \$379 | \$306 | \$379 | \$1,493 | \$1,765 |
| % change annual | 4% | 31% | 39% | 19% | 20% | 0% | -6% | 20% | 18% | 6% | 18% |
| % total operating revenue | 14.1% | 13.2% | 8.8% | 12.0% | 12.1% | 16.2% | 14.3% | 11.7% | 14.4% | 14.2% | 16.2% |
| Corporate expenses | 45 | 45 | 38 | 42 | 170 | 39 | 40 | 39 | 39 | 157 | 164 |
| Interest income | 18 | 12 | 10 | 8 | 48 | 6 | 4 | 5 | 5 | 20 | 37 |
| Interest expense | 56 | 55 | 54 | 55 | 220 | 56 | 65 | 60 | 54 | 235 | 207 |
| Investment income | 8 | (16) | (23) | 19 | (12) | (15) | (31) | 20 | 15 | (11) | 16 |
| Pretax operating income | \$356 | \$299 | \$150 | \$251 | \$1,056 | \$325 | \$247 | \$232 | \$306 | \$1,110 | \$1,447 |
| % change annual | -5% | 23% | -20% | 26% | 5% | -9% | -17% | 55% | 22% | 5% | 30% |
| Income tax expense | \$112 | \$88 | \$36 | \$56 | \$292 | \$109 | \$66 | \$68 | \$90 | \$290 | \$429 |
| Effective tax rate | 31.5% | 29.4% | 24.0% | 22.3% | 27.7% | 33.5% | 26.7% | 29.5% | 29.5% | 26.1% | 29.7% |
| Minority interest, net of tax | \$3 | \$2 | \$3 | \$3 | \$11 | \$4 | \$5 | \$3 | \$3 | \$15 | \$16 |
| Operating income from continuing operations—adjusted¹ | \$241 | \$209 | \$149 | \$192 | \$791 | \$206 | \$172 | \$160 | \$213 | \$751 | \$986 |
| % change annual | 6% | 49% | 86% | 113% | 47% | -199% | 232% | 187% | 191% | -2406% | 155% |
| Operating EPS | \$0.46 | \$0.41 | \$0.29 | \$0.37 | \$1.54 | \$0.40 | \$0.33 | \$0.31 | \$0.41 | \$1.45 | \$1.90 |
| % change annual | 3% | 41% | 56% | 53% | 31% | -14% | -19% | 7% | 10% | -6% | 31% |
| Average diluted shares | 519 | 512 | 516 | 514 | 515 | 515 | 522 | 518 | 519 | 518 | 520 |

¹Excludes all nonrecurring expenses/charges in all segments. Beginning 1Q09, also adjusted using the "two-class method" where earnings attributed to unvested shares are excluded.
Source: Company reports and William Blair & Company 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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