

First Mercury Financial Corporation

Quick First Look at Third-Quarter Results, Above Consensus, Property Losses Normalize After Disappointment Last Quarter

Highlights

- Third-quarter results above expectations.** First Mercury reported third-quarter operating EPS of \$0.39, \$0.04 above our estimate and \$0.02 above consensus. The upside was driven by a combination of factors, including higher net investment income, higher commissions and fees, and lower share count given continued share repurchase.
- Achieving moderate top-line growth given certain new business initiatives.** Gross premiums written increased 6.2%, to \$81.8 million, compared with our estimate of 3.5% growth, 16.2% growth in third quarter 2008, and 3.3% last quarter. Growth was driven by the launch of a new specialty business unit at the end of 2007 (FM Emerald—15% year-over-year premium growth, to \$13.0 million) and the inclusion of the new Professional Liability business unit launched February 2009 (\$6.1 million), the latter of which is ramping up after a slow start. The core businesses were a little more stable after significant pressure the past few quarters. The core security business was flat at \$15 million; the core specialty segment was down 10%, to \$30 million; and the contractors business actually flat at \$15 million. The market remains competitive and relatively unchanged from last quarter.
- Combined ratio in line with our estimate, property book shows improvement from disappointing second quarter.** The combined ratio was 92.5%, compared with our 92.3% estimate, 99.9% last quarter, and 86.3% in third quarter 2008. The loss ratio was 58.9%, compared with our 62.0% estimate, and the expense ratio was 33.6% compared with our 33.6% estimate. Favorable loss reserve development totaled \$1.3 million compared with our \$1.5 million estimate and \$3.6 million last quarter. We expect the higher expense ratio to moderate a bit in the near term.
- Investment gains boost healthy growth in book value.** Third-quarter GAAP EPS were \$0.89, including the impact from an \$8.7 million realized after-tax gain (\$13.5 million pretax) on the company's investment portfolio (approximately \$0.50 per share). This compares with \$9.5 million of pretax realized investment gains last quarter and \$10.6 million of pretax realized investment losses in third quarter 2008. Fully diluted book value per share ended the quarter at \$17.58, up 10.6% from second quarter 2009, and tangible book value increased 6.7%, to \$13.97, from second quarter 2009. The company repurchased roughly 413,665 shares of common stock during the third quarter for \$5.4 million, consistent with the \$5.1 million last quarter, and authorized a new share repurchase program for up to 1 million shares.

Financial | Commercial P/C Insurance

November 02, 2009

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

Symbol: FMR (NYSE)
Price: \$12.86 (52-Wk.: \$8-\$16)
Market Value (mil.): \$228
Fiscal Year End: December
Long-Term EPS Growth Rate: 15%
Dividend/Yield: \$0.04/0.3%

	2008A	2009E	2010E
Estimates			
EPS Q1	\$0.47	A\$0.41	NA
Q2	\$0.38	A\$0.30	NA
Q3	\$0.39	\$0.35	NA
Q4	\$0.43	\$0.34	NA
FY	\$1.74	\$1.40	\$1.85
CY		\$1.40	\$1.85

Valuation			
FY P/E	7.4x	9.2x	7.0x
CY P/E		9.2x	7.0x

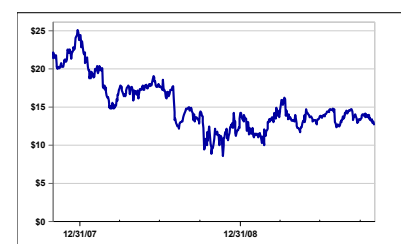
Trading Data (Thomson Financial)

Shares Outstanding (mil.)	18
Float (mil.)	NA
Average Daily Volume	109,096

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	22.0
Book Value Per Share (MRQ)	13.1
Enterprise Value (mil.)	263.9
EBITDA (TTM)	52.0
Enterprise Value/EBITDA (TTM)	5.1x
Return on Equity (TTM)	8.1

Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

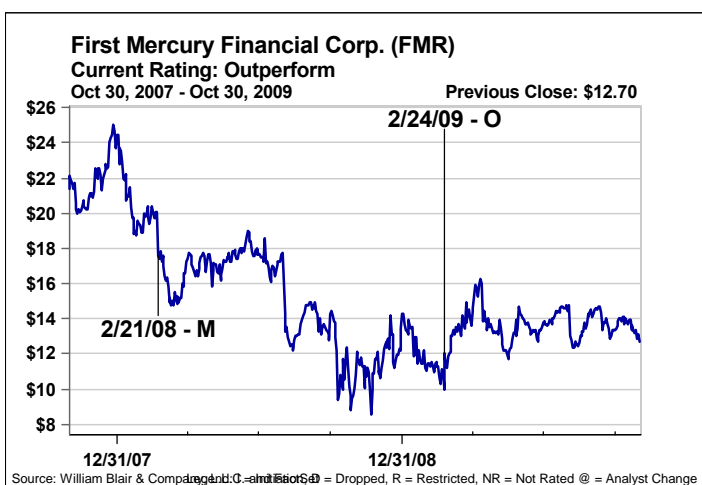
Mark Lane
312.364.8686
mlane@williamblair.com

Rachel Carter
312.364.8962
rcarter@williamblair.com

- **Management tightened its 2009 earnings guidance given stability in property book; we maintain Outperform rating.** Management tightened its 2009 operating EPS guidance range to \$1.45 to \$1.55 from \$1.30-\$1.60. The guidance range had been reduced last quarter from \$1.60-\$1.75 to account for the underperformance in the second quarter (\$0.15) and some modest potential adverse development on the remaining property book. We will revise our estimates after the conference call. The shares trade at a 27% discount to diluted book value per share and roughly a 22% discount to diluted book value per share excluding other comprehensive income, and we see no reason why First Mercury should not trade at a modest premium to book value excluding other comprehensive income today, given its profitability and growth profile.

William Blair & Company, L.L.C. is a market maker in the security of First Mercury Financial Corporation 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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William Blair & Company, L.L.C. 222 West Adams Street Chicago, Illinois 60606 312.236.1600 www.williamblair.com

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