

HCC Insurance Holdings, Inc.

Adverse Trends in Professional Liability

Summary: We have been expecting adverse loss trends in the professional liability segment, and this quarter reinforces our reasoning for why the stock should underperform going forward. HCC pre-released an increase in 2011 accident-year losses related to the first and second quarters of \$28.2 million, because of adverse trends in the diversified-financial-products lines of business in the professional liability segment. The company also reported estimated catastrophe losses of \$34.6 million.

Earnings revisions: We are adjusting our estimated EPS for the third quarter down from \$0.81 per share to \$0.54 per HCC's guidance of \$83 million of operating earnings for the quarter. We are keeping our 2012 earnings per share estimate firm at \$2.77.

Key Factors:

Enormous swings in prior-year reserve development. The adverse development in the diversified-financial-products segment of \$87.4 million was greater than the 2010 earned premium (\$75 million). To counterbalance this, HCC released \$88 million of prior-year reserves from the U.S. D&O, international D&O, and the U.K. professional-liability segments. This \$88 million represents 83% of fourth quarter 2010 earned premium and 20.4% of 2010 earned premium from these segments. These are uncharacteristically large swings, which would have created distorted calendar-quarter loss ratios if HCC did not combine the other sub-segment with U.S. D&O in the second quarter. Although the ability to release \$88 million from the professional liability segment's (excluding other) reserves is not something to be bearish about, the coincidence with the adverse development of \$87.4 million in the diversified financial products leads us to speculate that future reserve redundancies were pulled forward, and the prior year reserve development picture going forward is bleak.

Diversified financial products dragging down loss ratio. The \$28.2 million in adverse development on the 2011 accident-year from this segment, plus the \$87.4 million adverse from prior accident years, represents a loss of \$0.67 per share, or 28% of our 2011 revised earnings. The earned premium from this segment in 2010 was 5% of HCC's overall business in comparison. With a calendar-year loss ratio well in excess of 100% for 2011, this year exhibited the type of volatility that is possible when writing liability policies for financial institutions.

Increased volatility from catastrophe exposed business. With HCC's recent entry into the property treaty line of business, this has brought additional volatility to earnings because of recent catastrophe events. The loss ratio for this segment through the first half of the year is 103%, and it is likely for the third quarter to be a similar figure. The overall third-quarter catastrophe losses of \$34.6 million have brought down HCC's earnings per share in 2011 by \$0.20. Through the first nine months of 2011, catastrophes have cost HCC \$105 million, or \$0.61 per share.

Founded in 1974, HCC Insurance Holdings, Inc. is an international specialty property-and-casualty insurance holding company that underwrites and sells niche insurance products through a group of major subsidiaries known as HCC Insurance Group.

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Please consult the last page of this report for all disclosures.

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October 26, 2011

Stock Rating: **Underperform**
 Company Profile: **Core Growth**

Symbol: HCC (NYSE)
 Price: \$28.43 (52-Wk.: \$25-\$33)
 Market Value (mil.): \$3,321
 Fiscal Year End: December
 Long-Term EPS Growth Rate: 7%
 Dividend/Yield: \$0.62/2.2%

	2010A	2011E	2012E
Estimates			
EPS Q1	NA	A\$0.43	\$0.66
Q2	NA	A\$0.62	\$0.73
Q3	NA	\$0.54	\$0.73
Q4	NA	\$0.78	\$0.65
FY	\$2.96	\$2.37	\$2.77
CY		\$2.37	\$2.77
Valuation			
FY P/E	9.6x	12.0x	10.3x
CY P/E		12.0x	10.3x

Trading Data (Thomson Financial)

Shares Outstanding (mil.)	110
Float (mil.)	108
Average Daily Volume	808,292

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	12.6
Book Value Per Share (MRQ)	21.9
Enterprise Value (mil.)	3,301.1
EBITDA (TTM)	467.2
Enterprise Value/EBITDA (TTM)	7.1x
Return on Equity (TTM)	9.7

Two-Year Price Performance Chart



Sources: Thomson Financial, William Blair & Company estimates

Bottom Line: The deterioration in the professional liability segment is consistent with our statutory reserving analysis that found HCC's statutory other liability claims-made reserves deficient. We reiterate our Underperform rating in the name as we expect the reserve development trends in the professional liability segment to depress earnings in future quarters.

**HCC Insurance Holdings, Inc.
Other Liability Claims-Made
Statutory Incurred Loss Ratios by Accident Year (%)**

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months	Points of Development
2001	NA	NA	NM	NM	NM	NM	NM	NM	NM	NM	XXX
2002	49.10	49.14	42.08	37.16	5.80	35.49	32.30	30.74	58.64		9.54
2003	49.56	50.23	56.04	53.41	38.29	40.05	31.06	26.22			(23.34)
2004	52.67	50.60	52.79	44.96	39.90	38.94	37.88				(14.79)
2005	52.12	52.57	51.97	44.89	39.99	39.58					(12.54)
2006	55.88	55.30	52.00	47.38	46.85						(9.03)
2007	57.06	60.66	65.46	63.48							6.42
2008	61.61	72.82	74.91								13.30
2009	62.96	67.88									4.92
2010	61.50										0.00

Source: SNL

**HCC Insurance Holdings, Inc.
Unfavorable (Favorable) Prior-Year Development
(dollars in thousands)**

	2008	2009	2010	2011 Q1	2011 Q2
Professional Liability (GAAP)	-18,675	-674	9,624	5,000*	10,800*
U.S. Other Liability Claims-Made (Statutory)	-36,306	20,836	20,408	NA	NA
All Lines of Business (GAAP)	-82,371	-53,524	-22,663	9,000	13,300

* Estimated

Source: Company reports, SNL, and William Blair & Company, L.L.C.

**HCC Insurance Holdings, Inc.
Professional Liability Segment GAAP Net Loss Ratio**



Sources: Company reports and William Blair & Company, L.L.C. estimates

HCC Insurance Holdings, Inc. and Subsidiaries

Earnings Model

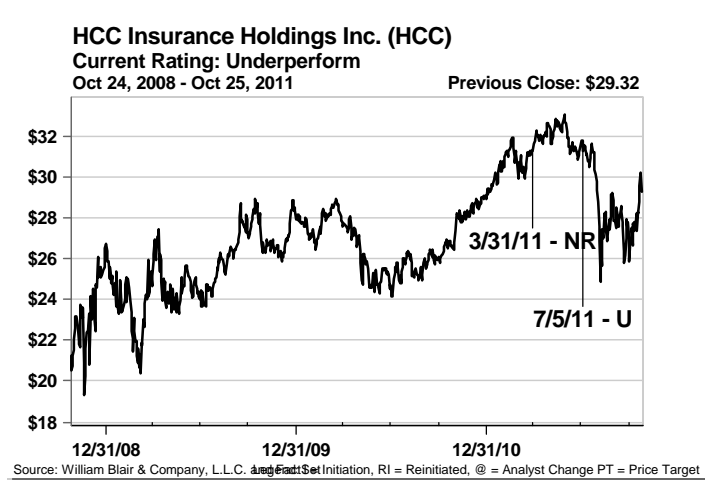
(dollars in thousands except per share data)

	2009	2010	1Q'11	2Q'11	3Q'11E	4Q'11E	2011E	2012E
Gross written premium	2,559,791	2,578,908	649,208	742,082	661,255	632,176	2,684,721	2,810,060
Net written premium	2,046,289	2,026,197	538,884	609,873	512,823	493,025	2,154,605	2,265,984
Net earned premium	2,037,235	2,041,924	508,480	524,251	534,777	537,847	2,105,354	2,226,730
Net investment income	191,965	203,819	51,595	52,422	52,517	53,685	210,219	213,635
<i>% yield</i>	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%
Other operating income	82,669	44,832	7,321	7,475	7,888	9,797	32,481	32,481
<i>% change</i>	44.5%	-45.8%	-59.2%	0.0%	0.0%	0.0%	-27.5%	0.0%
Total Revenue	2,311,869	2,290,575	567,396	584,148	595,181	601,329	2,348,054	2,472,847
Loss and loss adjustment expense, net	1,215,759	1,213,029	347,586	334,282	357,503	314,244	1,353,614	1,365,777
<i>% Loss Ratio</i>	59.7%	59.4%	68.4%	63.8%	66.9%	58.4%	64.3%	61.3%
Policy acquisition costs, net	308,554	322,046	83,378	84,483	85,264	85,983	339,108	365,366
<i>% Policy acquisition cost ratio</i>	15.1%	15.8%	16.4%	16.1%	15.9%	16.0%	16.1%	16.4%
Other operating expense	259,488	256,004	64,312	63,748	64,565	71,300	263,926	285,816
<i>% Other operating expense ratio</i>	12.7%	12.5%	12.6%	12.2%	12.1%	13.3%	12.5%	12.8%
Interest expense	16,164	21,348	5,553	5,434	5,280	5,441	21,708	21,708
Total Expense	1,799,965	1,812,427	500,829	487,947	512,612	476,968	1,978,356	2,038,667
Operating Earnings before income tax expense	511,904	478,148	66,567	96,201	82,570	124,360	369,698	434,180
Income tax expense	162,357	140,643	17,180	27,181	22,294	39,174	105,828	136,767
<i>tax rate</i>	31.7%	29.4%	25.8%	28.3%	27.0%	31.5%	28.6%	31.5%
Operating earnings	349,547	337,505	49,387	69,020	60,276	85,187	263,870	297,413
					0.202			
Operating earnings per share	\$3.09	\$2.96	\$0.43	\$0.62	\$0.54	\$0.78	\$2.37	\$2.77
<i>% change</i>	10.5%	-4.3%	-27.8%	-13.9%	-33.0%	-5.9%	-20.0%	17.1%
Net realized investment gain (loss)	12,076	12,104	-559	3,000	3,000	3,000	8,441	12,000
Realized investment gains net of tax	7,849	7,868	-363	685	1,950	1,950	5,487	7,800
Other-than-temporary impairment credit losses	-5,429	-425	-3,129	0	0	0	-3,129	0
OTT impairment credit losses net of tax	-3,529	-276	-2,034	-228	0	0	-2,261	0
Net earnings	353,868	345,096	46,990	69,478	62,226	87,137	267,096	305,213
Net earnings per share	\$3.13	\$3.02	\$0.41	\$0.62	\$0.56	\$0.80	\$2.40	\$2.84
Basic average shares outstanding (millions)	112.2	113.9	113.8	111.4	110.6	108.8	111.2	107.0
Diluted average shares outstanding (millions)	113.1	114.1	114.1	111.8	110.9	109.1	111.5	107.3
Cash dividends per share	0.520	0.560	0.145	0.145	0.145	0.145	0.580	0.600
Operating ROE	12.3%	10.6%	6.0%	8.4%	7.3%	10.2%	8.0%	8.5%
Book Value per average diluted share	26.80	28.89	28.99	29.25	29.90	31.04	30.38	33.80

Sources: Company reports and William Blair & Company, L.L.C. estimates

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Additional information is available upon request.



Current Rating Distribution (as of 09/30/11)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	59	Outperform (Buy)	8
Market Perform (Hold)	31	Market Perform (Hold)	2
Underperform (Sell)	1	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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