

HCC Insurance Holdings, Inc.

Second-Quarter Earnings: Underlying Trends Are a Concern

Summary

We are reaffirming our Underperform rating on HCC. The second quarter looked solid, but underlying trends showed potential weakness. Operating EPS came in at \$0.62, which compares with our estimate of \$0.63 and consensus of \$0.61. However, assuming a normalized tax rate (31.5%) and previous share base, the quarter would have been closer to \$0.58. On the negative side, the quarter showed materially higher professional liability losses and was the second consecutive quarter with overall company adverse development. Going forward, downside to our below-consensus 2012 estimate is a possibility.

Earnings Summary

We are reaffirming our 2012 earnings per share estimate of \$2.78, which is \$0.26 below consensus of \$3.04. Downside of \$0.24 earnings per share is possible if the professional liability loss ratio is 80% in 2012 compared with our projected 70%. In addition, a business mix shift to an increased catastrophe oriented book should add volatility to earnings. This shift could result in as much as \$0.28 earnings per share upside or \$0.63 downside to our 2012 number.

Key Factors

Deteriorating professional liability profitability: Our base projection for 2012 assumes a 70% net loss ratio. If there is significant prior-year adverse development, this could result in an 80% net loss ratio, which would subtract \$0.24 from our 2012 earnings per share estimate. The professional liability line of business has experienced adverse development for two quarters in a row and we expect this to continue, although it may not happen every quarter. A certain amount of adverse development is baked into our estimate of a 70% net loss ratio in 2012; however, we see a possibility that the loss ratio will be materially worse than our expectations.

Increasing property treaty and energy premium could add volatility: We expect the property treaty and energy combined earned premium to increase from \$50 million in 2009 to \$200 million in 2012. These lines of business are catastrophe-oriented and have the potential to add earnings volatility. Our current forecast assumes a 48% loss ratio for 2012. This loss ratio could be anywhere from 25% to 100%, which could provide an upside of \$0.28 earnings per share or downside of \$0.63 earnings per share.

Bottom line: Despite the stock being down, we recommend that investors steer clear. Pressure from the professional liability book and a higher level of catastrophe-oriented business suggest that return on equity will be lower and potentially more volatile. The stock looks inexpensive at just below book value, but actually remains expensive at roughly 8 times cash flow.

Financial Services | Property & Casualty Insurance

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

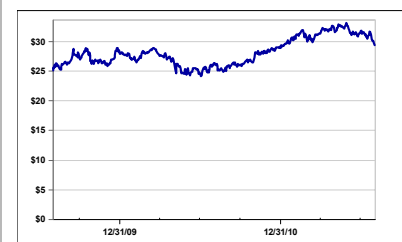
Symbol: HCC (NYSE)
Price: \$28.60 (52-Wk.: \$25-\$33)
Market Value (mil.): \$3,389
Fiscal Year End: December
Long-Term EPS Growth Rate: 7%
Dividend/Yield: \$0.58/2.0%

	2010A	2011E	2012E
Estimates			
EPS Q1	NA	A\$0.43	\$0.67
Q2	NA	A\$0.62	\$0.73
Q3	NA	\$0.81	\$0.74
Q4	NA	\$0.78	\$0.65
FY	\$2.96	\$2.63	\$2.78
CY		\$2.63	\$2.78
Valuation			
FY P/E	9.7x	10.9x	10.3x
CY P/E		10.9x	10.3x

Trading Data (Thomson Financial)	
Shares Outstanding (mil.)	114
Float (mil.)	111
Average Daily Volume	604,651

Financial Data (Thomson Financial)	
Long-Term Debt/Total Capital (MRQ)	12.6
Book Value Per Share (MRQ)	21.9
Enterprise Value (mil.)	3,365.1
EBITDA (TTM)	490.6
Enterprise Value/EBITDA (TTM)	6.9x
Return on Equity (TTM)	9.9

Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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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.

William Blair & Company, L.L.C. receives or seeks to receive compensation for investment banking services from HCC Insurance Holdings, Inc. Investors should consider this report as a single factor in making an investment decision.

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

Earnings Forecast Summary

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Key Factors

Deteriorating professional liability profitability: Our base projection for 2012 assumes a 70% net loss ratio. If there is significant prior-year adverse development, this could result in an 80% net loss ratio, which would subtract \$0.24 from our 2012 earnings per share estimate. The professional liability line of business has experienced adverse development for two quarters in a row and we expect this to continue, although it may not happen every quarter. A certain amount of adverse development is baked into our estimate of a 70% net loss ratio in 2012; however, we see a possibility that the loss ratio will be materially worse than our expectations. In addition, as the profitability of this business segment is declining, HCC has been taking on a higher retention of its gross written premium, which is a concern given the soft pricing environment and deteriorating calendar-year loss ratio.

HCC Insurance Holdings, Inc. Professional Liability Effect on 2012 EPS Expectations

	WB Expectation		
	Scenario 1	Scenario 2	Scenario 3
Calendar Year Loss Ratio for Professional Liability	60%	70%	80%
PL Earned Premium	\$398,186	\$398,186	\$398,186
Total Company Expense Ratio	25%	25%	25%
PL Combined Ratio	85%	95%	105%
PL Underwriting Income	\$58,932	\$19,113	(\$20,706)
Tax Rate	35%	35%	35%
2012 EPS Contribution from PL	\$0.36	\$0.12	(\$0.13)
Total Company Operating EPS for 2012	\$3.02	\$2.78	\$2.54
% Difference From WB Expectation	9%	0%	-9%

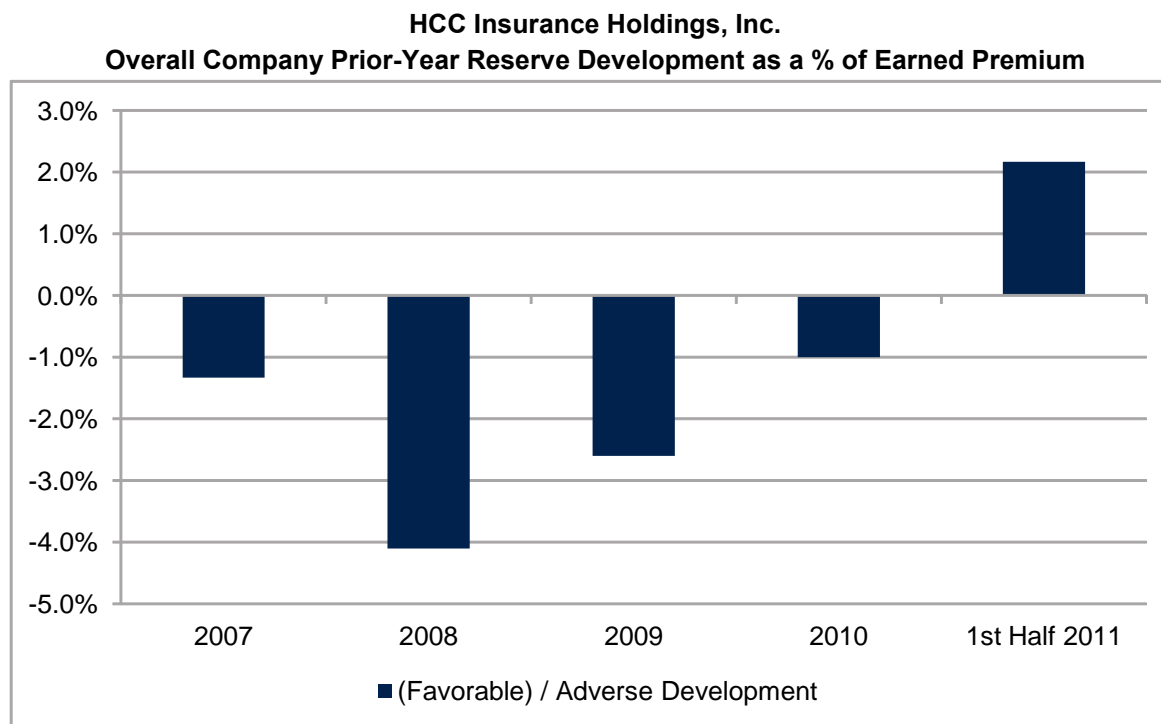
Sources: Company reports and William Blair & Company, L.L.C.

Gross written premium was flat compared with the second quarter of 2010; however, the net written premium was up by 8%. With the casualty market being very soft, there is not a lot of room for growth, so taking on a larger amount of retention is a better strategy than trying to write a higher amount of new business (if you have the goal of growing). However, we do not believe at this point in the insurance pricing cycle that it is a profitable strategy to grow in the professional liability market, so we view this increase in net written premium as more of a risk to earnings than a catalyst.

The professional lines loss ratio increased to 70% for the second quarter compared with 66% in the first quarter and 60% a year ago. The U.S. segment was the main driver, with a loss ratio of 72% compared with 66% in the first quarter and 63% for full year 2010. We had expected professional lines to deteriorate (our forecast loss ratio was 65%), but this quarter was even worse than our expectations.

Based on the loss trends we are seeing, the probability of our bear case is increasing. The professional liability prior-year adverse development in the second quarter was \$10.8 million, or 10.5% of professional liability earned premium. Based on the earnings call disclosure, we estimate the professional liability prior-year adverse development was anywhere from 3% to 5% of first-quarter professional liability earned premium. Prior-year adverse development can have a significant effect on the loss ratio, and with HCC's business mix (20% professional liability), this can add material downside to earnings. This is a trend that needs to be watched closely.

The overall company prior-year reserve development is displayed in the graph below. As illustrated in the figure, HCC's earnings were helped in 2008 by 4.1% of prior-year favorable development, but the amount of favorable development declined in 2009 and 2010. In the first half of 2011, HCC has had 2.2% of prior-year adverse development, a 3% delta from 2010 and a 6% delta from 2008. This has a material impact on earnings, and if adverse development continues, it will cause both earnings and stock valuation to decline.



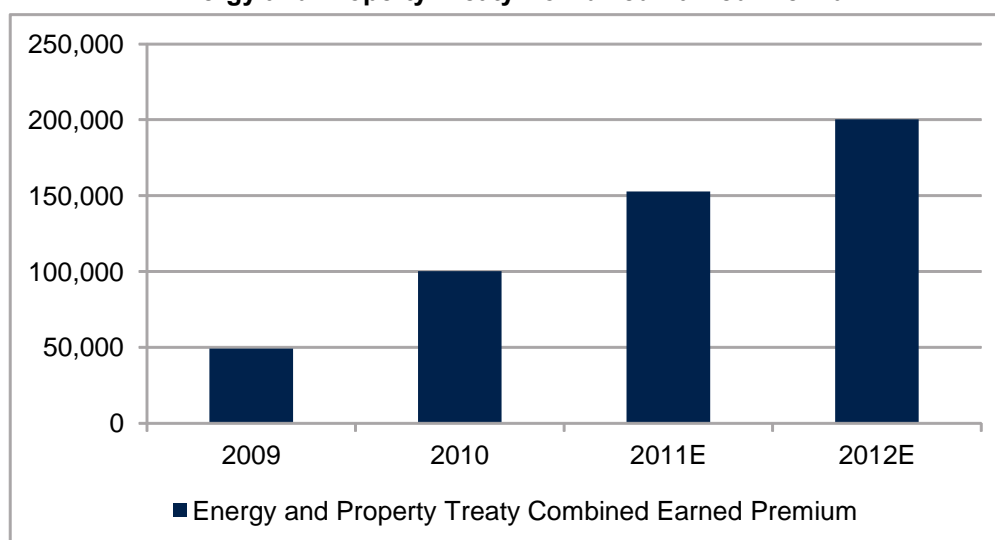
Source: Company reports

Increasing property treaty and energy premium could add volatility: We expect the property treaty and energy combined earned premium to increase from \$100 million in 2010 to \$200 million in 2012. These lines of business are catastrophe oriented, which will create earnings volatility going forward.

Our current forecast assumes a 48% loss ratio for 2012. This loss ratio could be anywhere from 25% to 100%, which could provide an upside of \$0.28 or downside of \$0.63 to earnings per share.

HCC saw strong growth in the second quarter in the international energy and property treaty lines of business. For the first half of the year, these segments are up 33% and 76%, respectively; combined, the increase was 54%. Our forecast has energy and property treaty earned premium growing from \$100 million in 2010 to \$153 million in 2011 and \$200 million in 2012. We expect property treaty to have \$121 million of earned premium in 2012, compared with essentially a nonexistent book in 2009.

HCC Insurance Holdings, Inc.
Energy and Property Treaty Combined Earned Premium



Source: Company reports

Energy and property treaty are catastrophe-oriented lines of business that have high volatility. They can be very profitable when catastrophes do not hit—but when catastrophes occur, the loss ratio can jump enormously. Property treaty had loss ratios of 126.7% in the first quarter of 2011 and 86.4% in the second quarter; this compares with 58.2% for full year 2010. The energy line of business ran loss ratios of 25.7% in 2009 and 22.2% in 2010, yet in the first half of 2011, this loss ratio jumped to 60%. This volatility can have a major impact on earnings, especially as these lines of business grow.

Our energy and property treaty scenario analysis shows how the large volatility can have an impact on earnings. One thing to note is that the book of business has a skewed loss distribution, as we believe it is more likely to have a calendar-year loss ratio of 25% than 100%. If the combined lines of business have a 100% calendar-year loss ratio, this would subtract \$0.63 from our projected 2012 earnings per share. If the year has a lower-than-expected number of catastrophes, a 25% calendar-year loss ratio would translate into an additional \$0.28 in 2012 earnings per share.

HCC Insurance Holdings, Inc.
Energy and Property Treaty Combined Scenario Analysis

	WB Expectation		
	Scenario 1	Scenario 2	Scenario 3
Energy and Property Treaty Net Loss Ratio	25%	48%	100%
Energy and Property Treaty Earned Premium	\$200,282	\$200,282	\$200,282
Total Company Expense Ratio	25%	25%	25%
Energy and Property Treaty Combined Ratio	50%	73%	125%
Energy and Property Treaty Underwriting Income	\$99,740	\$53,676	(\$50,471)
Tax Rate	35%	35%	35%
2012 EPS Contribution	\$0.60	\$0.33	(\$0.31)
Total Company Operating EPS	3.06	2.78	2.15
% Difference From WB Expectation	10%	0%	-23%

Source: Company reports and William Blair & L.L.C. estimates.

HCC Insurance Holdings, Inc. and Subsidiaries

Earnings Model

(dollars in thousands except per share data)

	2007	2008	2009	2010	1Q'11	2Q'11	3Q'11E	4Q'11E	2011E	1Q'12E	2Q'12E	3Q'12E	4Q'12E	2012E
Gross written premium	2,451,179	2,498,763	2,559,791	2,578,908	649,208	742,082	661,255	632,176	2,684,721	698,774	795,375	675,471	640,440	2,810,060
Net written premium	1,985,609	2,060,618	2,046,289	2,026,197	538,884	609,873	512,823	493,025	2,154,605	581,942	654,364	527,584	502,093	2,265,984
Net earned premium	1,985,086	2,007,774	2,037,235	2,041,924	508,480	524,251	534,777	537,847	2,105,354	544,011	554,973	562,384	565,362	2,226,730
Net investment income	206,462	164,751	191,965	203,819	51,595	52,422	52,517	54,159	210,693	55,319	52,414	53,387	54,363	215,483
% yield		3.4%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%
Other operating income	96,780	57,214	82,669	44,832	7,321	7,475	7,888	9,797	32,481	7,321	7,475	7,888	9,797	32,481
% change		-40.9%	44.5%	-45.8%	-59.2%	0.0%	0.0%	0.0%	-27.5%	0.0%	0.0%	0.0%	0.0%	0.0%
Total Revenue	2,288,328	2,229,739	2,311,869	2,290,575	567,396	584,148	595,181	601,803	2,348,528	606,651	614,862	623,659	629,522	2,474,694
Loss and loss adjustment expense, net	1,183,947	1,211,873	1,215,759	1,213,029	347,586	334,282	309,342	314,244	1,305,453	334,714	334,384	342,469	354,210	1,365,777
% Loss Ratio	59.6%	60.4%	59.7%	59.4%	68.4%	63.8%	57.8%	58.4%	62.0%	61.5%	60.3%	60.9%	62.7%	61.3%
Policy acquisition costs, net	279,753	303,816	308,554	322,046	83,378	84,483	85,264	85,983	339,108	90,836	91,099	91,353	92,078	365,366
% Policy acquisition cost ratio	14.1%	15.1%	15.1%	15.8%	16.4%	16.1%	15.9%	16.0%	16.1%	16.7%	16.4%	16.2%	16.3%	16.4%
Other operating expense	241,642	233,509	259,488	256,004	64,312	63,748	64,565	71,300	263,926	70,438	69,149	69,586	76,644	285,816
% Other operating expense ratio	12.2%	11.6%	12.7%	12.5%	12.6%	12.2%	12.1%	13.3%	12.5%	12.9%	12.5%	12.4%	13.6%	12.8%
Interest expense	10,304	16,288	16,164	21,348	5,553	5,434	5,280	5,441	21,708	5,553	5,434	5,280	5,441	21,708
%		84.3%												
Total Expense	1,715,646	1,765,486	1,799,965	1,812,427	500,829	487,947	464,451	476,968	1,930,195	501,541	500,066	508,687	528,373	2,038,667
Operating Earnings before income tax expense	572,682	464,253	511,904	478,148	66,567	96,201	130,731	124,834	418,333	105,110	114,797	114,972	101,149	436,027
Income tax expense	185,825	141,323	162,357	140,643	17,180	27,181	41,180	39,323	124,863	33,110	36,161	36,216	31,862	137,349
tax rate	32.4%	30.4%	31.7%	29.4%	25.8%	28.3%	31.5%	31.5%	29.8%	31.5%	31.5%	31.5%	31.5%	31.5%
Operating earnings	386,857	322,930	349,547	337,505	49,387	69,020	89,550	85,512	293,470	72,001	78,636	78,756	69,287	298,679
Operating earnings per share	\$3.31	\$2.80	\$3.09	\$2.96	\$0.43	\$0.62	\$0.81	\$0.78	\$2.63	\$0.67	\$0.73	\$0.74	\$0.65	\$2.78
% change		-15.4%	10.5%	-4.3%	-27.8%	-13.9%	-0.4%	-5.5%	-11.0%	54.0%	18.4%	-8.9%	-17.1%	5.7%
Realized investment gains net of tax	8,572	-18,162	7,849	7,868	-363	685	1,950	1,950	5,487	1,950	1,950	1,950	1,950	7,800
OTT impairment credit losses net of tax			-3,529	-276	-2,034	-228	0	0	-2,261	0	0	0	0	0
Net earnings	395,429	304,768	353,868	345,096	46,990	69,478	91,500	87,462	296,695	73,951	80,586	80,706	71,237	306,479
Net earnings per share	\$3.38	\$2.64	\$3.13	\$3.02	\$0.41	\$0.62	\$0.83	\$0.80	\$2.66	\$0.68	\$0.75	\$0.75	\$0.67	\$2.86
Basic average shares outstanding (millions)	112.9	114.8	112.2	113.9	113.8	111.4	110.6	108.8	111.2	107.7	107.3	106.8	106.4	107.0
Diluted average shares outstanding (millions)	117.0	115.5	113.1	114.1	114.1	111.8	110.9	109.1	111.5	108.0	107.6	107.1	106.7	107.3
Cash dividends per share	0.42	0.47	0.520	0.560	0.145	0.145	0.145	0.145	0.580	0.15	0.15	0.15	0.15	0.600
Operating ROE		12.7%	12.3%	10.6%	6.0%	8.4%	10.8%	10.1%	8.8%	8.4%	9.0%	8.8%	7.6%	8.4%
Book Value per average diluted share	20.86	22.86	26.80	28.89	28.99	29.25	30.16	31.31	30.65	32.17	32.90	33.65	34.30	34.09
GAAP net loss ratio	59.6%	60.4%	59.7%	59.4%	68.4%	63.8%								
GAAP net expense ratio	23.8%	25.0%	24.3%	25.2%	26.3%	25.4%								
GAAP combined ratio	83.4%	85.4%	84.0%	84.6%	94.7%	89.2%								
Paid loss ratio	47.9%	58.1%	55.8%	59.7%	58.4%	64.5%								
Accident Year Loss Ratio	60.9%	64.5%	62.3%	60.4%	66.6%	61.3%								
Accident Year Combined Ratio	84.7%	89.5%	86.6%	85.6%	92.9%	86.7%								
CAT losses					9.8%	3.9%								

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

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Additional information is available upon request.



Current Rating Distribution (as of 07/31/11)

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